THE FREEMAN

IDEAS ON LIBERTY

The Seven Deadly Fallacies of Bad Economics

Paying People Not to Grow

Protectionism: The Myths

OCTOBER 1986

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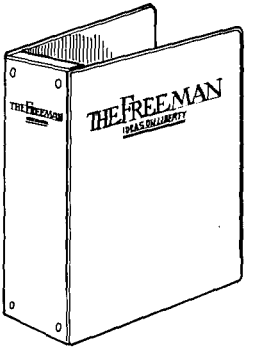

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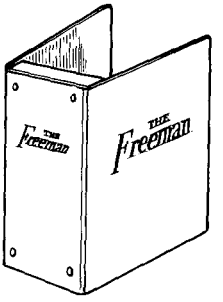

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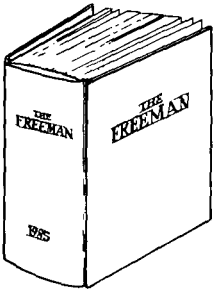

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IDEAS ON LIBERTY

CONTENTS
OCTOBER
1986
VOL. 36
NO. 10

364 Paying People Not to Grow
Robert James Bidinotto
Government aid stifles personal initiative, diminishes self-esteem, and reduces our potential for moral self-responsibility.

370 Protectionism: The Myths
J. R. Kearl
A penetrating analysis of the popular misconceptions which threaten world trade.

379 Protectionism: A Threat to Individual Freedom
Stephen Lai
Trade barriers reduce consumer choices and raise the prices of protected foreign goods and competing domestic products.

381 Protectionism and Agricultural Price Supports
E. C. Pasour, Jr.
The contradiction between domestic price supports and international free trade.

384 The Seven Deadly Fallacies of Bad Economics
John K. Williams
Critical economic errors which lead to poverty and destruction.

392 Freedom and Failure
Dwight R. Lee
The freedom to attempt success requires an accompanying freedom to fail.

396 A Reviewer's Notebook
John Chamberlain
A review of James R. Cook's "The Start-Up Entrepreneur."

397 Other Books
"Money and Freedom," by Hans F. Sennholz. "Destroying Democracy: How Government Funds Partisan Politics," by James T. Bennett and Thomas J. DiLorenzo. "Making Sense of Marx," by Jon Elster.

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IDEAS ON LIBERTY

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PERSPECTIVE

Food from Thought

A recent ad for a seafood restaurant noted that more than 70 per cent of the earth's surface is water which, in their words, "teems with millions and millions of lunches and dinners." But, the ad went on, "it takes genius to get them out."

What the ad didn't say is that the "geniuses" who supply consumers with seafood as well as other goods and services are entrepreneurs who hope to earn a profit. Fish and shellfish have lived in the oceans for millennia. It took profit-seeking entrepreneurs to bring them to dinner tables across the nation.

Now, as growing demand endangers some species—shrimp and Pacific salmon, for example—other entrepreneurs see the potential shortages as opportunities. One entrepreneur is raising shrimp as a commercial venture in Hawaii. Another has transported salmon eggs from the Pacific Northwest to South America, where the cold rivers of Chile offer conditions similar to those in the Columbia River. At last word, young salmon had returned up river to spawn in Chile where they had hatched.

When entrepreneurs are free to seek profits, they will risk their own resources to try to meet consumer needs. But if they are discouraged by rules, regulations, and confiscatory taxes, we consumers will be the ones to suffer.

—BBG

A Little Doubt

Sometimes a little doubt can be the beginning of great wisdom.

Consider the case of Leszek Kolakowski, a Polish philosopher. For years he was hailed as the top Marxist theoretician of his country. But quietly seeds of doubt took root in Kolakowski's mind. He became a "revisionist Marxist," regarded with suspicion and barely tolerated by the authorities. Then came

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his departure from Poland and, in time, the publication of a three-volume study tearing Marxism—classical and revisionist—to shreds. More recently, Kolakowski has been uttering sentiments to which students of the freedom philosophy can only warm. Doubt, for him, was a pathway to truth.

"The world is flat." Copernicus dared doubt, and a new vision of our planet and solar system came to life. "No person can sail beyond narrowly determined limits!" Columbus doubted, and a new continent destined to be the home of a free people was discovered. "If one party to an economic exchange profits, the other party must have lost!" Adam Smith doubted, and an economic system capable of enriching all drew nearer to its realization. "The laws of physics have been stated once and for all by Newton!" Einstein doubted, and an exciting new understanding of energy and its transformations was born.

Hence the "doubt" the freedom philosophy applauds. We cherish the truths we have discovered—an open mind, after all, is not to be confused with an empty head! Yet equally we cherish the knowledge that further truths await discovery by those humble enough to doubt that they already know it all!

—John K. Williams

Freedom to Fail

We Americans tend to take our liberties for granted. We have enjoyed so much liberty for so long and have been so sheltered from real oppression that we have lost to a great extent an understanding of the nature of liberty and the reverence for liberty that was so deeply rooted in our forebears. In particular, we don't seem to appreciate as a people the trade-offs between freedom and security. We have "progressed" from seeing government as merely the securer of our basic rights to life and the liberty to pursue happiness in our own ways so long as we respect the rights of others to a perverted perception of government as the securer of a host of new "rights" that might be lumped together as the *achievement* of happiness as opposed to the altogether different right to *pursue* happiness. These so-called rights to "decent" housing, a "decent" meal and a "decent" job at "decent" pay would readily have been seen as the insidious threats to liberty that they are by the founding fathers of this country whose philosophical insights were infinitely deeper than are those of the shallow politicians who govern today.

It is not so surprising that Americans have lost their intellectual moorings insofar as liberty is concerned. Few people understood at the time of the Great Depression that it was essentially produced by the government (the Federal Reserve had been created less than fifteen years earlier) and fewer still were able to understand that an amalgam of New Deal legislation enacted under a personally appealing President effectively dragged out an economic recovery that would doubtless have proceeded much more rapidly under a more free and efficient market. Traumatized by the prolonged economic insecurities of those times, people were willing to trade some liberty for a square meal—and the image of government as economic savior has persisted despite mounting evidence of its inability to fill that role.

—William Chidester
Market Vantage
July 4, 1986

(Ed. note: For further insights into the importance of the freedom to fail, see Dwight R. Lee's "Freedom and Failure," beginning on page 392.)

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THE FREEMAN
IDEAS ON LIBERTY

Paying People Not to Grow

by Robert James Bidinotto

MOST Americans believe that the rewards of life should be individually earned. That is why few government programs have been subjected to as much public criticism as the policy of paying farmers *not* to grow crops. The very idea of rewarding non-production affronts most people's notions of justice and common sense.

This does not mean that Americans oppose all government aid or subsidy programs on principle. Confusing the functions of government with those of a private insurance firm, many believe that the state should provide a social "safety net" for those regarded as innocent victims of life's hardships.

Originally, such assistance programs were intended only for the helplessly needy: the sick and disabled, the very young and the very old, those laid low by catastrophes. The presumed beneficiaries' helpless dependency was regarded as an ethical claim upon the community—and thus a moral rationale for coercive redistribution of private wealth from the "haves" to the "have-nots."

However, even in the most severe cases of individual need, coercive redistributionism poses irreconcilable moral dilemmas. It seeks to help some people—but necessarily at the expense of others. It aims to relieve those designated as "victims"—by creating a new class of "victims": those forced to provide the relief. It designates some people as *ends*—while it arbitrarily relegates other people to the servile status of *means*.

There is an unbridgeable gap between the moral *intentions* underlying redistributionism, and its moral *consequences*. Redistributionism is intended as a charitable "spreading of wealth"; in fact, it is a compulsory spreading of burdens. It is intended to solve individual problems; in fact, it universalizes hardships. It is intended to make men morally responsible for others; in fact, it obliterates any concept of personal responsibility.

By shifting some people's personal burdens, problems, and hardships onto the backs of others, redistributionism has corrupted and undermined the vital principle of moral self-responsibility. It encourages those with personal problems to neglect their moral responsibility to seek personal solutions; and it entices them to depend instead upon the coercive power of government to extort assistance from others. Simultaneously, it punishes with taxation those who have assumed their moral responsibility to work, solve their own problems, and support themselves.

Like the policy of paying farmers not to grow crops, redistributionism pays *people* not to grow . . . as people.

In his controversial book, *Losing Ground*, Charles Murray formulated a "Law of Unintended Rewards." It states that "any social transfer increases the net value of being in the condition that prompted the transfer." It does so "either by increasing the rewards or by reduc-

Mr. Bidinotto is contributing editor for On Principle, *a political newsletter, and received the 1985 Mencken Award in journalism for "Best Feature Story, Essay or Review."*

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ing the penalties'' normally associated with the condition, or behavior, which the government is trying to ameliorate.

For example, Social Security is intended to insure against financial problems associated with old age. But it does so by removing the need (incentive) for many people to prepare other financial options for their retirement years. In addition, Social Security taxes siphon off their means of investing in any alternative. So, instead of adding to the security of the elderly, the program encourages many of them to ignore long-term planning—hence, to increase their vulnerability to hardship—and hence, to become overly dependent upon it as an exclusive, rather than supplementary, source of income. In effect, Social Security has increased the rewards and reduced the penalties of inadequate financial planning—the very problem which the program was designed to combat.

The Human Cost of Federal Aid

Similarly, Aid to Families with Dependent Children was intended to help widows with small children. Murray shows, with devastating examples,[1] how AFDC benefits encourage poor women to have more and more illegitimate children, while discouraging them from marrying their live-in lovers. The enormous proliferation of inner-city illegitimacy, generations of welfare dependents, and attendant moral problems (such as crime, drug epidemics, and the like), is a grim testament to the Law of Unintended Rewards. In other words, AFDC increases the rewards and reduces the penalties of becoming an unmarried woman with dependent children—the very problem which the program was designed to alleviate.

In the same way, Federal disaster relief is intended to compensate victims of catastrophic losses due to various disasters. Much of this Federal money goes to victims of coastal flooding during hurricanes—a phenomenon so predictable that certain areas of the country are officially designated as hazard zones. Federal flood insurance is offered to individuals living in these zones at only about a third of private insurance rates. Flood victims typically use their Federal insurance compensation for reconstruction . . . right back in the hazardous zones. In effect, the Federal assistance increases the rewards and reduces the penalties of building and living in dangerous areas. By increasing the number of people at risk, the federal government thus increases the magnitude of future disasters—the very problem which the program was designed to relieve.[2]

The economic consequences of redistributionism are well known, and are not of primary concern here. What these examples illustrate is a different, and perhaps even more important point: the *human* cost of Federal ''assistance.'' Redistributionism invariably demoralizes both its presumed beneficiaries and its involuntary benefactors. It pays people not to grow—in ability, in foresight, in productive output, in moral character.

If this is so even in extreme cases of individual hardship, what can be said of those government programs designed to assist able-bodied, normally productive people?

Because of the inverted morality of the redistributionist welfare state,[3] it was only a matter of time before the category of ''needy'' people expanded. With mounting incentives to become recipients, and massive disincentives to remain producers, the growth of the welfare state began to acquire its own momentum. More and more voters began to clamor for broader and less restrictive criteria for obtaining political assistance.

Politicians have met the demand for unearned benefits by increasing the supply of redistributionist programs. In 1950, there were 4.2 wage earners for every recipient of a Federal ''transfer payment.'' By 1980, there were only 1.6 wage earners per recipient. Transfer payments were 3.8 per cent of the Gross National Product in 1952; by 1982, they were 12.2 per cent. They were less than half of the Federal budget in 1962; today, they amount to two-thirds of all government outlays. By 1984, the federal government was running 400 separate programs to give subsidies to individuals. And this does not even begin to count up state and local programs and outlays.[4]

Fueling this proliferation of programs was the addition of the ''deserving'' to the category of the ''needy'' as eligible recipients. Even considering the vagaries of terminology, ''needs''

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can at least be specified and somewhat delimited. But given today's ill-defined and competing standards of justice, the notion of "deserving" is utterly elastic. And it does not necessarily limit government assistance only to the helplessly dependent. Once helplessness was no longer the sole standard of determining who could receive government aid, more and more able-bodied people began to line up for unearned benefits.

Veterans' Benefits

For example, it was first argued that military veterans "deserved" compensation for injuries and traumas sustained during service to their country (a reasonable position). But no distinction between "compensation" and "benefits" was ever drawn. So, a vast array of "veterans' benefits" has been made available to present and former military personnel—whether or not they have seen combat, sustained service-related injuries, or are even "needy."

Take medical care for veterans. The Veteran's Administration maintains its own system of 172 hospitals, 93 nursing homes, 227 outpatient clinics and a variety of other facilities—the nation's largest health care network. Its facilities are antiquated and grossly inefficient compared with those in the private sector. And though the V. A. is not obligated to do so, over 80 per cent of its care is provided for *non-service-related* disabilities.[5]

Obviously, veterans' benefits are not strictly limited to meeting the actual "needs" of soldiers injured in the line of duty. Rather, they are intended to express public feelings of gratitude and indebtedness to all military personnel as such. Because such feelings are intangible and unquantifiable, the public can place no objective limit on what they feel veterans "deserve."

But the unlimited largess of veterans' programs has a negative side. It fosters and perpetuates dependency among military personnel, providing them with a buffer and a refuge from civilian life and the private market. It pays veterans *not* to grow.

Similarly, Americans tend to feel that workers "deserve" government assistance in times of hardship. Just as military personnel "deserve" unlimited compensation for taking risks for their country, unemployed workers "deserve" compensation above and beyond that which they receive for their labors alone. Evidently, they also ought to be paid for the virtues of character presumably implied in being "workers." Thus, even when they are *not* working, they "deserve" compensation . . . for their past record of hard work.

This premise seems to be a dilution of the labor theory of value into the popular notion that anyone exerting himself (regardless of how well he meets market needs) "deserves" to be compensated for his effort alone. The idea that it is not results, but mere efforts—or even mere good intentions—which merit some reward, is deeply ingrained in popular values. And it implies that if "society" (the private market) fails to give a hard-working or well-meaning person his "due," then government ought to force "society" to make amends, through various interventions.

One of those interventions, intended to alleviate the "undeserved suffering" of the unemployed, is the unemployment compensation program. Since 1935, unemployment compensation has provided jobless workers with incomes. Never mind that unemployment compensation—in effect, a subsidy for idleness—discourages workers from seeking new jobs.[6] The *intentions* of a government policy, as always, take precedence over its *consequences*. Thus, unemployment compensation pays workers *not* to learn new skills, to seek new opportunities, to move to better locations . . . to grow.

At least unemployment compensation retains some connection to the original rationale for redistributionist programs: the unemployed are, presumably, helplessly dependent until they find new work. But thanks to the labor theory of value, the government offers aid not only to the helpless, but to those who are merely struggling.

Consider the plight of the farmer. It is government intervention which has caused the chronic agricultural crises since the First World War.[7] Decades of price supports, protective tariffs, government purchases of farm surpluses, subsidies for reducing production (paying farmers *not* to grow crops), "marketing orders" to restrict supply, and low-interest loans have combined to produce an oversupply of

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farm products . . . and farmers.

Beyond its economic benefits, an end to government intervention in agriculture would prompt thousands of uncompetitive farmers to abandon an anachronistic lifestyle, to learn new skills more appropriate to a modern economy, to become truly self-supporting and independent. But in response to loud cries of anguish, the current Administration is continuing the same failed policies of the past. Those policies not only pay farmers not to grow certain crops; they pay farmers not to grow . . . as self-responsible individuals.

In fact, we are facing a mounting clamor for additional government programs to shield not only farmers, but fishermen, shoemakers, garment manufacturers, oil producers, and steel workers from foreign competition or disruptive market changes. Even people who usually oppose welfare schemes are campaigning for government aid to "save the family farmer" . . . loan guarantees for troubled auto manufacturers . . . tariff protection for struggling domestic steel and shoe producers . . . intervention to "revitalize" local communities dependent upon dying technologies and industries.

In each of these cases, uncompetitive or obsolete professions are being salvaged from the economic scrap heaps by infusions of government capital . . . capital drained from more competitive and productive sectors of the economy. And in each case, the alleged "victims" are demanding their "right" to be sustained, via compulsory taxation, in lines of work which consumers are unwilling to sustain voluntarily. They are demanding, in effect, the right to be paid *not* to grow—the right to stagnate.[8]

"Desirable" Causes

Now, to the categories of the "needy" and the "deserving," has been added the category of the "desirable." Federal funds are available for every conceivable cause which sounds appealing, or even merely innocuous, to those holding the Federal purse strings. There is a wry joke making the rounds, which says, "If it moves, regulate it; if it stands still, tax it"—to which we may now add: "If it sounds good, subsidize it."

Sounds good—to whom? Desirable—by whose judgment? The free market rewards producers to the extent that they offer goods and services which appeal to a large number of people. If one wished to invent a mechanism for satisfying the broadest range of desires of the greatest number of people, one could not improve upon the market system. At best, government interventions on behalf of "desirable" enterprises would be superfluous: they would mirror those selections made by consumers, voting with their dollars.

But of course, that is *not* what advocates of Federal aid to "desirable" causes mean. They intend not to mirror the democratic selections of the people—but to override them. The only "desires" they intend to indulge and reward from the public treasury are their own. Unable to win public support in the marketplace, they mean to impose their values upon the public from the halls of Congress—or, at the very least, to compel the public to finance their self-indulgence.

This coercive elitism is most evident in government support of artists, through the National Endowment for the Arts. Those most likely to get government grants are those of high visibility—those already successful or those who learn the corridors in Washington better than they learn their own profession.

What does this mean in terms of personal growth?

It means that many commercially unsuccessful artists (whose work is frequently obscure, offensive, or of poor quality) are sustained in a profession for which they are unsuited—and are thus diverted from pursuing a more appropriate career. Commercially successful recipients, on the other hand, obtain funds they do not need, at the expense of those who do.

Meanwhile, art consumers, as taxpayers, have less to spend on the kind of art which uplifts them intellectually and spiritually. Instead, they are compelled to subsidize art they find personally unrewarding or even offensive. (The evil is compounded in the case of the National Endowment for the Humanities, where taxpayers are forced to subsidize *ideas* which they may find repugnant or evil.) This means there is less money for artists whose work is moving and accessible to greater numbers of people. And thanks to redistributionism, it is not un-

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common that some struggling artists—too proud, independent, or politically unsophisticated to obtain handouts—are forced to subsidize their less scrupulous, more politically "connected" competitors.

Government support of the arts pays artists not to grow.

"Entitlements"

Today, it is no longer helplessness . . . or need . . . or the belief that one is a "deserving" person . . . or even "social desirability" that fuels the race for government assistance. As their tax burdens mount, as programs dispensing assistance proliferate, as eligibility requirements evaporate, citizens are concluding that a life of self-responsibility is less and less rewarding. Mutual plunder has become the status quo. And, in such an atmosphere, taxpayers increasingly feel *entitled* to the benefits of programs which they are required to support.

The notion of "entitlements" is even broader than the idea of "deserving" government assistance. "Deserving" implies that the recipient is being rewarded for an action, quality, or status that merits special treatment. There is at least a residual sense of justice involved. But the concept of "entitlements" obliterates any pretext of a standard of eligibility: one is "entitled" to benefits simply because they are available. The ubiquitous phrase of our time is: "I paid into the system, so I'm going to get my share."

Not long ago, a book appeared by a man who runs a business to teach clients how to milk the Federal system for funds. Titled *Getting Yours*,[9] the book represents the zenith of the "entitlement" mentality. "If you want to build a house or a chicken coop, get a job, start a business, get a college degree, improve your neighborhood, or even build a tennis court or a golf course, it is likely you can do it with funds from the federal government," enthuses the author. "So don't believe all the headlines about budget cuts, because the federal government continues to give out more money than ever before." Reassuring, isn't it?

In an essay-review,[10] I outlined some examples taken from the book:

"Your taxes helped the National Endowment

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for the Humanities give nine students $10,000 to walk 412 miles, following the exact route of the historic 'Underground Railroad.' Young scholars receive an average of $14,000 to work with Smithsonian specialists on such pathbreaking projects as 'The 1940s in New York—Radical Politics and Avant Garde Art' or the 'Socio-ecology of Venezuelan Red Howler Monkeys' . . . (or) . . . 'Feminism and Its Impact on the Premises and Goals of Current Political Theory' . . .

"A Killington, Vermont, ski lodge, hurt by the 1974 fuel crisis, was saved by a $40,000 loan from the SBA while you waited in line for gas . . . The Agriculture Dept. poured seed money into Kinnen, Alabama, to help raise an unusual crop: tennis courts, a baseball diamond, picnic grounds and a playground. And (a famous ex-baseball star)—obviously among the nation's downtrodden—got a $100,000 loan guarantee from the SBA to buy a Dodge dealership . . .

"You also fund cutting-edge technology . . . (T)he Dept. of Energy gave a Missouri genius $1,200 to design and build a solar-heated outhouse."

Such is the dead-end of redistributionism. All the old justifications are gone; all that is left is a feeding frenzy at the public trough.

It is common for some critics to view redistributionism on strictly economic grounds—as inefficient, as wasteful of resources, as destructive of capital. But the real price of redistributionism cannot be conveyed in macro-economic aggregates or impersonal market relationships. The real tragedy of redistributionism lies in its stultifying impact on human development.

Full Self-Responsibility

Growth, development, maturation, self-actualization: whatever one chooses to call it, it is the essence of life. In the final analysis, it means the exercise of full self-responsibility—intellectually, morally, materially. The ancient Greeks put it more elegantly. The true end of human life, they said, was personal well-being, which they defined as "the exercise of vital powers, along lines of excellence, in a life affording them scope."

Redistributionism, in the guise of government assistance, thwarts every element of human potential. It inhibits the exercise of vital powers, diverts them along inappropriate lines, shrinks their scope and scale.

Of course, government assistance is always promoted on the grounds that it helps recipients to grow or develop in some manner. Critics often respond that if government assistance has this effect on a given recipient, it is only at the expense of someone else, whose personal growth must be sacrificed. And, as far as it goes, this criticism is true: government-fostered "growth" is inherently parasitical, even cannibalistic. But that is not the worst of it.

The truth is that there are *no* winners under redistributionism—only losers. Everyone is diminished by the process of plunder—including the plunderer. Whatever the presumed beneficiary gains in material advantages is more than offset by the price—in lost independence and moral self-responsibility, in lost incentives to achieve, in lost self-esteem . . . in a lost legacy of personal potential.

Many observers have commented on the disappearance of heroes from the modern world. Nothing is so characteristic of this century as the ever-shrinking stature of its leaders. There are probably many reasons why towering figures no longer cast their shadows across the land. Surely one of them is that a Procrustean force has been loosed upon the world—a force that punishes those who stand too conspicuously, and rewards them for remaining bowed—a force that pays *people* not to grow. □

1. Charles Murray, *Losing Ground* (New York: Basic Books, 1984), pp. 154-166.
2. John W. Sommer, "Disasters Unlimited," *The Freeman* (April, 1986), pp. 135-36.
3. R. J. Bidinotto, "The Exploitation of the Virtuous," *The Freeman* (September, 1968), p. 568.
4. J. Peter Grace, *Burning Money* (New York: Macmillan, 1984), pp. 107-8.
5. *Ibid.* See also William R. Kennedy and Robert W. Lee, *A. Taxpayer Survey of the Grace Commission Report* (Ottawa, IL: Green Hill Publishers, 1984), pp. 79-80.
6. Hans F. Sennholz, "Unemployment Compensation," *The Freeman* (May, 1986), pp. 188-89.
7. Dennis Bechara, "The Continuing Plight of Agriculture," *The Freeman* (May, 1986), pp. 178-85.
8. Frank W. Bubb, "The Right to Stagnate," *The Freeman* (April, 1986).
9. Matthew Lesko, *Getting Yours—The Complete Guide to Government Money* (New York: Viking Penguin, Inc., 1984).
10. R. J. Bidinotto, "Parasitism as a Profession," *On Principle* (April 29, 1985).

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Protectionism: The Myths

by J.R. Kearl

For at least 200 years it has been clearly understood that opening an economy to trade increases real per capita income, and that this increase is larger the more open an economy becomes. In our modern age, though, almost everyone who is not an economist thinks that imports reduce profits and eliminate jobs, that an economy would best be served by exporting more and importing less, and that a trade surplus would be good while a trade deficit is most certainly bad. Each of these notions is false but very much a part of the rise of protectionism in the United States.

In perhaps no other area of social policy are there so many myths that are so demonstrably incorrect yet so persistently invoked. But this gives rise to a nice puzzle: If free trade is such a terrific thing, why do protectionist myths persist and why are we moving step by step away from an open trade environment at great costs to each of us?

The positive effects that liberal or open trade have upon economic well-being or, conversely, the negative effects that protectionist policies have on our welfare are more than abstract ideas of academic scribblers. The historical record is quite clear.

The growth and power of the American economy are a direct result of the movement away from the Articles of Confederation to a union of states within which trade between states could not be taxed. The Constitution essentially created a free trade area among the original 13 states and ensured that the free trade area would automatically increase with the creation of new states. Your economic well-being would be substantially lower if there were now 50 separate economies in this country, each with its own protected "basic" industries, rather than the integrated and specialized economy we now have. This fact might prompt you to ask why free trade between Montana and Florida is good but open trade between Alberta and Florida is not.

Likewise, all of our real incomes are substantially higher because the city of Provo cannot impose a tariff on the importation of clothing by the citizens of Provo from the mall in Orem and because Utah cannot impose a tariff on the importation of lettuce from California. Imagine, if you can, what our economic position would be if there were a tariff wall around Provo, or any of this country's cities, so high that we had to manufacture within the city all of the typical commodities we consume—shoes, televisions, cars, refrigerators, computers, and so on. Our living standards would be much lower because economic independence produces, quite simply, economic poverty.

Britain's move toward free trade in the early part of the nineteenth century, culminating with the repeal of the Corn Laws (laws that severely restricted the importation of grains in the support of domestic agriculture), ushered in almost a century of unparalleled economic growth. Those who supported the Corn Laws argued that wages would fall if trade was not restricted.

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In fact, wages within Britain rose rapidly with more open trade. However, not just the British benefited from the repeal of the Corn Laws. As a consequence of this move toward freer trade, Britain was the engine of economic growth for the world in the nineteenth century. (It is useful to note that Britain did not demand reciprocal actions by her trading partners, and indeed many continued to pursue protectionist or mercantilist policies to their detriment.)

On the negative side, there is now a good deal of evidence that the severity, depth, and length of the Great Depression were directly related to the unprecedented tariffs imposed by the Smoot-Hawley Act in 1930 and to similar actions taken by other countries in reaction to this tariff.

Furthermore, following World War II, as the colonies of the European powers obtained political independence, they also pursued economic independence and sought to restrict trade. All available evidence indicates that this effort to be economically independent stunted economic growth and impoverished these economies and their citizens. By contrast, those less developed areas that pursued more open economic policies, notably Hong Kong, Singapore, Taiwan, and South Korea, have experienced remarkable economic growth. For example, 1960 per capita income in the Philippines was $163 while it was $139 for Taiwan. By 1980, income in the Philippines had increased to $665, a four-fold increase, while it had increased to $2269 in Taiwan, or by a factor of 16. While there are many differences between the Philippines and Taiwan, one of the important differences was the pursuit of more protectionist policies by the Philippines.

The Myths of Protectionism

Despite the obvious achievements of open trade and the costs associated with restricted trade, protectionist myths persist.

Myth #1: An economy with high labor costs must protect itself because it cannot compete with an economy benefiting from "cheap" labor.

The benefits from trade depend only upon relative production costs, not on the level of production costs. Every economy has a relative cost advantage in some activity. For example, if you compare U.S. production costs in each of its industries with those of a low-wage country, say South Korea, you will find that those activities with relatively high U.S. costs will mostly be undertaken in Korea, while those with relatively low U.S. costs will be undertaken here. Higher labor productivity and lower capital costs allow us to have lower relative production costs in some activities, while lower labor costs allow South Korea to have lower relative production costs in other areas.

This myth suggests that we can only benefit from trade by trading with those countries that are "similar" to us. In fact, the gains from open trade are greater the more dissimilar the economies with whom we trade—our relative cost advantages and their relative cost advantages are greater and as a consequence the positive effects on per capita income in both economies will be greater.

It should also be noted, as an empirical matter, that the U.S. is not being driven from the international market place by "low" wage competition. The vast majority of our trade occurs with Canada and the European Economic Community, both of which have wage patterns comparable to our own. Even the wage pattern in Japan, our next largest trading partner, is closer to our own than to those in the less developed areas of the world. Conversely, little trade occurs with most of Africa, an area of truly low wages.

Myth #2: Import restrictions save American jobs.

In fact, import restrictions destroy American jobs. Free trade will move jobs from high relative cost sectors of an economy that cannot compete to low relative cost sectors that can. This occurs because imports undermine high-cost domestic activities, but since imports are paid for with dollars, when those dollars are spent by foreigners in the U.S., they increase employment in exporting sectors. It is true that when there is protection, there will be more people employed in the protected activities, but this will be at the cost of fewer people employed elsewhere in the economy.

Moreover, because real per capita income is

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higher with free trade, the average worker will have a smaller real income under protectionist policies. Indeed, estimates of the annual costs to consumers of distorting the distribution of jobs through protectionist policies are generally between $100,000 and $300,000 per job. More bluntly, we are paying well over $100,000 to maintain the jobs of people earning considerably less than $100,000.

Finally, it should be noted that the effect of trade on long-term employment is generally small when compared to other determinants of employment, even though in a protectionist environment all job losses are attributed to trade. For example, recent estimates indicate that in the steel industry, 209,000 jobs were eliminated between 1976 and 1983 because of a long-term decline in the demand for steel while only 37,000 jobs were lost (reallocated) because of import competition. The recessionary difficulties of the late 1970s and early 1980s accounted for the loss of another 27,000 jobs.

Myth #3: Temporary protection can provide a breathing period for an industry to modernize and become more competitive.

While temporary protection does create higher returns in activities under competitive pressure, it also reduces the incentives for adjustment. If there are technologies or organizational changes that will make an industry competitive, the expected profits will provide the necessary capital for such investments, regardless of protectionist barriers. If, on the other hand, no technology or organizational change will make an industry more competitive, then the increased income that temporary protection creates will not be reinvested by a rational manager but will be devoted to other activities. Consequently, the evidence indicates that once protection is granted, productivity and unit costs generally deteriorate even further relative to other industries. It is no surprise that the steel industry has enjoyed some form of protection for the past 15 years without notable recovery or that protectionist policies have not returned the U.S. to its once dominant position in the manufacture of televisions and footwear. Textiles have been provided temporary protection in anticipation of finally becoming viable in the international and open national market since the 1820s, giving new meaning to the word *temporary.*

However, while temporary protection does little to assist a domestic industry to adjust to international competition, many forms of protection, particularly those that currently are being employed, help foreign producers because they enable them to increase the prices they charge for imports to the United States. In both the automobile and steel industries, so-called voluntary agreements to limit exports to the United States have increased substantially the profits of foreign producers. For example, the external quotas imposed by the U.S. during the 1970s are estimated to have increased the annual profits of Japanese steel firms by about $200 million, or about one-half of Japan's annual expenditure on research and development in steel. Our assistance to the domestic automobile industry has benefited the Japanese producers and dealers by at least $2 billion per year. Best estimates are that the external quota arrangement with the Japanese increased the price of Japanese cars by about $900 per car and the price of U.S. cars by about $350 per car—a total cost to consumers of $4.3 billion, or about $160,000 per year per job "saved" in the automobile industry.

Myth #4: Bilateral trade should be balanced.

Of particular concern these days is the $35 billion or so trade deficit with Japan. Even if one could argue that a trade deficit, per se, mattered, it certainly cannot be argued that a deficit with any particular country matters. Suppose, for example, that we purchase $10 billion in manufactured goods from the Japanese, who purchase $10 billion in raw materials from the Indonesians who, in turn, purchase $10 billion in food from the United States. Each country would be running a deficit with at least one other country, but the total trade deficit for each would be zero since each is also running a surplus with at least one country. More important, our ability to run an export surplus with the Indonesians would depend fundamentally on our export deficit with the Japanese. If we eliminated trade with the Japanese in order to get rid of the bilateral trade deficit, we would make it impossible for the Indonesians to run a surplus with us. More precisely, a refusal to import

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goods from Japan, demanding bilateral balanced trade, would result in a decrease in U.S. exports to other countries. It is important to understand that trade restrictions ostensibly directed at imports are always restrictions on exports as well; a tariff is always a tax on exports even though it appears to be a tax on imports alone.

It should be emphasized that where we have made large international loans (to Brazil, Mexico, South Korea, et al.), it would not be possible for those countries to pay off the loans unless we ran trade deficits with them, that is, unless they export more to us than we do to them—with the difference being equal to the payment on the loan. Part of the current international debt crisis is a direct result of our refusal to accept in payment (i.e., to import) the goods these debtor nations produce.

There is an important sense, then, in which trade is always balanced: If we import more goods than we export, we must be exporting dollars or the ownership of dollar denominated assets. This is an essential fact in understanding international trade. We can only import more goods than we export if foreigners willingly accept and hold these pieces of paper, and they can only get these pieces of paper if they exchange real goods and services for them. Except for possible adjustment costs associated with changing foreign preferences to hold these pieces of paper, this arrangement cannot possibly hurt us.

Myth #5: The United States will one day become a debtor nation if it continues to have large trade deficits.

This myth is true, but empty. Indeed, the U.S. became a net debtor during 1985, but here the word "debtor" gets in the way of understanding. If you incur a personal debt, you must produce income to pay off the debt. If our government runs a domestic deficit, it must also produce income to make payments on the debt. If a foreign country borrows dollars from the United States, that country must produce a dollar income to make payments on that debt. In each of these cases, domestic and foreign, the debt implies some future obligation, an IOU.

The U.S. trade deficit implies no such obligation. In the simplest case, we trade dollars for goods. Dollars are not IOUs, and they can only be spent in one economy, our own. Moreover, we can trade dollars for goods only so long as foreigners are willing to hold dollars. When they are unwilling to do so, we will have to trade goods for goods as foreigners use the dollars they have accumulated in the only way that they can, to purchase U.S. goods. If they do not want U.S. goods and do not want U.S. dollars, then an adjustment will occur in the value of the dollars that foreigners are holding so as to limit the amount of importing the U.S. can do. This is the only potential cost—that at some point in the future we will not be able to consume more than we produce as we have been able to for the past several years because of the willingness of foreigners to hold dollars.

Myth #6: We should protect U.S. industries from subsidized foreign goods that hurt American industries and consumers.

While it is difficult to know when a price difference is the result of a difference in efficiency rather than an explicit subsidy by a foreign government, there is little doubt that many governments subsidize the production of goods that enter the international markets. It is important to understand what this means, however. It is simply this: A foreign government taxes its citizens, thereby cutting their consumption, so that it can subsidize the consumption of people living in the richest country in the world. While paternalistic instincts may lead us to discourage this activity, we should not do so on the grounds that this activity is hurting Americans. If the rest of the world wants to provide welfare payments to us, we probably ought to humbly accept their largess. Our real income is certainly higher as a consequence.

It should be noted, though, that we are not without dirty hands in this matter. For example, while we undoubtedly have a comparative advantage in the production of agricultural commodities, the Department of Agriculture's budget, which has fluctuated between $18 and $35 billion over the past several years, is almost totally a subsidy to agricultural production that we are anxious to export. This is an indirect but very large subsidy of the goods that we expect other countries to buy from us. Moreover, we have directly subsidized exports of, for exam-

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ple, wheat to Egypt and shipping services. In the latter area, the U.S. merchant marine fleet, which competes in the international shipping market, stays afloat solely because of governmental subsidies.

Myth #7: Free trade for a country can only be beneficial if it is reciprocal, that is, if others are protectionist, we should be protectionist.

What happens if we trade freely with a country that is protectionist? If a country refuses to allow U.S. goods to penetrate domestic markets but exports aggressively to the U.S., it trades real goods (e.g. cars, televisions, clothing) for paper money (U.S. dollars). This poses no problem for the country getting the real goods; we should be concerned only if the U.S. were pursuing a policy that resulted in a long-term systematic surplus.

It is important to point out, however, that we have an interest in freer trade by our trading partners since to the degree that restrictive or mercantilist policies by others lower the amount of trade that occurs, we are not as well off as we might be. In this sense, reciprocity matters. The gains here are only on the upside, however, and a nation that is freely trading with others only hurts itself with protectionist policies. The benefits of a unilateral movement toward free trade by the British in the last century were noted earlier.

It may also be the case that reciprocity is necessary to create an open or free trade political coalition where trade liberalization is sold on the notion that with reciprocity, foreign markets will become open and that we cannot expect to export without importing. Essentially, reciprocity arguments may be used to play off the mercantilist sentiments that exports will be increased more than imports in order to create a more open trading environment.

Myth #8: The effects of protectionism are isolated to the industry protected.

For virtually every country except possibly the U.S. (because of our unique position as the world's banker), decreasing imports decreases exports, and a tariff, quota or voluntary agreement on imported steel, for example, is essentially a tax on all exports.

The effects are even more direct than this, however. In 1985 the U.S. steel industry felt a sense of triumph because our government had persuaded the Japanese to "voluntarily" decrease their exports of steel to the U.S. The effect of this agreement, and others like it that we have forced on virtually all the steel producing nations of the world, will be to increase the price U.S. manufacturers pay for steel. While this may be advantageous to steel producers, there is more than one way to import steel: You can either import it as steel to be used in the production of final goods here, or the final goods, embodying steel, can be produced abroad and imported. Because of the potential for this kind of substitution, all U.S. manufacturers of goods using steel are now at a competitive disadvantage with foreign producers of those same goods; and while we will import less raw steel, we will now begin to import more steel embodied in final goods. The effect of this "advantageous" agreement is to place all U.S. industries that use steel in a "disadvantageous" position.

As another example, it is clear that protectionist measures that increase the price of domestic copper relative to foreign copper will lead to the destruction of more jobs in copper fabricating industries (because products with copper will be fabricated abroad) than will be saved in the copper mining industry. It is likely that these industries will then go to the government complaining about import competition and seeking relief. Like a cancer, protectionism will then spread.

Myth #9. Finally, it is often asserted that we must protect "basic" industries or, as a variant of this myth, those essential to national defense.

The vitality of the economy as a whole is not linked with the prospects of any particular industry. Indeed, the hallmark of a robust and growing economy is that the basic industries change through time. Railroads and agriculture were basic industries a hundred years ago. If we had pursued more aggressively domestic and international policies that protected these industries, 80 per cent of us would still live on the farm and none of us would easily be able to drive or fly. Because of the relationship be-

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tween importing and exporting, when we adopt a trade policy that preserves our historical industrial base and freezes structural change, we impede structural change, not just in the U.S. but around the globe.

There are certainly legitimate national security needs, but protectionism is the most inefficient method of providing for them.

Kernels of Truth

Debunking these myths has been, perhaps, too much of an academic exercise, yet the central point is quite simply put: Under virtually any circumstances you can imagine, protectionism lowers our economic well-being considerably. If you look only at the costs of tariffs and domestic quotas, excluding the numerous voluntary agreements, the lower end of the estimate was $75 billion in 1984, which is a hidden tax of almost $1300 for each family of four. The true loss is likely several times this figure.

I am not suggesting that we pursue protectionist policies in this country because we do not understand the consequences or because the myths are convincing and we have been fooled. This would imply that a little education would stem the tide of protectionism and that ideas would triumph as we establish our trade policies. Rather, these myths are essentially the clothing for naked self-interests. A full explanation of the decline of free trade depends upon identifying both particular protectionist interests and a policy process that allows these special interests to outweigh the interests of all of us.

While each of these myths is false, each, as with most myths, contains a kernel of truth; indeed, there are three basic kernels that keep these myths alive.

1. Free trade increases per capita real income, but to do so it forces adjustments in the economy.

In practical terms, this means that while free trade creates new jobs in some sectors of the economy, it also causes unemployment in other sectors. Moving from one activity to another is not without cost, even if one's income doesn't change. Thus, to return to a specific myth, foreign subsidies are of concern not because they undermine the U.S. economy but because if they are not permanent or if they fluctuate greatly, they impose recurring adjustment costs on U.S. industries and on the individuals employed in those industries.

2. Free trade increases per capita real income, but it also changes the distribution of income within an economy.

As a result of free trade, some people's incomes may fall, even though average individual income across the economy increases. Of course, it is little solace to unemployed steel or copper workers who have been making hourly wages well above the national industrial average that there are lower paying jobs elsewhere in the economy that they can find or that the average income for their fellow Americans is higher because theirs is now lower.

It is important to remember that protectionism, while lowering average real income, does increase someone's income. Free trade produces winners and losers, but the gains of the winners are larger than the losses of the losers, while protectionist policies produce gains for the winners that are smaller than the losses of the losers.

3. Free trade increases real per capita income, but it leads to economic interdependence.

Thus, the increase in income is associated with our linkage to other economies—our well-being, in some senses, is tied to theirs.

Keeping the Myths Alive

These three kernels of truth give the myths their staying power. Ideas and historical evidence create no political coalitions. But adjustment costs, worries about economic interdependence, and narrowly focused losses that are only offset by broadly spread gains do create political coalitions. More precisely, a group of workers at a particular factory being forced to find work elsewhere—perhaps initially at a lower salary—forms the basis for a potent political coalition. Not surprisingly, the political system responds to such political coalitions.

Lyndon Johnson once said that a politician couldn't be for free trade because there were no votes in it. Thus, our political representatives,

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while often voicing allegiance to free or open trade as a general principle, virtually always find that there are special circumstances associated with particular industries in their districts that call for protectionist responses.

While the adjustment problems associated with changes in employment opportunities and incomes of particular workers may elicit a sympathetic response, neither need be present for groups with narrow interests to seek protectionist policies. Because such policies will increase the incomes of certain individuals, the policies will always attract political interest. As a consequence of this incentive and the resistance to adjustment noted earlier, protectionism is used as a subtle private tax and transfer scheme to increase the incomes of selected individuals.

The government's intervention in the sugar market illustrates this point. The world price of sugar is between 2 and 3 cents per pound, but because of protectionist policies, the price in the United States is over 20 cents per pound. That is, each of us pays over 10 times the world price for the sugar we consume. This amounts to a little less than $100 per year for a family of four, so it is not worth it for any of us to fight the policies that create the disparity in prices. For the small number of sugar producers in this country, however, the additional amount families spend sums to millions of dollars each year. Indeed, the annual amount spent on sugar, beyond that which would be spent if we freely traded in the commodity, is equal to half the capital value of all domestic sugar producers.

In addition, the annual expenditures per family do not fully measure the costs of protectionist policies in this area because, as noted earlier, it is not possible to isolate the effects of such policies. In particular, it is easy to import sugar in other foodstuffs, such as candy bars or pasta, but doing so places this country's producers of these products at a competitive disadvantage with foreign producers.

Where does all this lead? The government now protects us from imported chicken and turkey pot pies, lemon curd, white chocolate, chocolate sauces, sweetened cocoa, pancake mixes, sweetened flour and mousse mixes, sprinkles for ice cream and toppings for Black Forest cake, herb teas, mussel salad, Korean noodles in a soup base, and frozen kosher pizzas. Shipments of each of these have been prevented from entering the U.S. during the past year because they contain sugar.

The convenience of manipulating the concern over sugar importation as a lever for protectionist policies is perhaps nowhere better illustrated than by noting that the mussel salad that was prevented from entering the U.S. contained less than 1.7 per cent sugar and the Korean noodles were in a soup base with less than .02 per cent sugar.

The "Fairness" Doctrine

All such protectionist policies are devices by which small groups, with much to gain, use the political process to force the rest of us to pay for their well-being. That the true subsidies of these protectionist policies are hidden explains their attraction to politicians and protected individuals and businesses.

Protectionist policies, then, may be appealing, but protectionist rhetoric is not. Everyone is for open trade—as a general matter. However, there has been a subtle change even in the rhetoric. In much of the debate, people no longer speak of "free trade"; instead, it is now popular to stand for "fair trade." Those interested in protectionism have used that great shibboleth of contemporary life, "fairness," to mask protectionist policies and, increasingly, the debate is between "fair" and "unfair" trade rather than between "free" trade and "protectionism." Thus, no one is in favor of "protectionism," but, increasingly, people favor "fair" (read protectionist) trade and not "free" trade.

This shift in rhetoric has accompanied a shift in the kinds of protectionist policies we pursue. Tariffs were once the common means of intervening in international trade, but, increasingly quotas and "voluntary" export restraints by our trading partners dominate our trade policy.

Part of this movement away from tariffs accompanied the development of the world trading system following World War II. The United States emerged as the dominant economy following the War and with some extraordinary guidance recognized that an open trading system was important for the future stability of the Western countries. As a consequence, the U.S.

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pushed for the development of a number of international institutions that would facilitate international trade and economic development. Among them was the General Agreement on Trade and Tariffs (GATT), a treaty that committed the U.S. and the other industrial nations of the West to lowering tariffs from the historic highs reached during the Great Depression. In many respects, this treaty has been successful beyond anyone's expectations. Average tariffs on industrial products for us and our trading partners have declined through a series of negotiations from 59 per cent (following the Smoot-Hawley tariff) to less than 5 per cent today.

However, other changes have created an environment more conducive to protectionism. First, with the growth of economies elsewhere, the U.S. economy has become more integrated into the world economy and relatively less dominant. Trade from the rest of the world is now much more important to us, but, at the same time, we are now a less important trading partner for any particular country. As a consequence, goods in our economy now face direct competition from abroad, many for the first time, and we have less leverage on the trade policies of other countries.

Second, the movement toward more open trade coincided with a long-term decline in some politically important and "basic" U.S. industries, including textiles, footwear, machine tools, steel, and copper. This created hostility toward what people easily identified as the "cause" of this decline—open trade—even though most of the problems had other sources.

Third, lower tariffs did create a more open U.S. economy. However, other countries, which historically had relied more on non-tariff barriers, were less affected by these lower tariffs. These economies have become relatively less open as a consequence of the decline in tariffs. In addition, non-tariff barriers, which were made obscure and unimportant by high tariffs, have now become much more visible, important, and irritating to the U.S.

A simple example will illustrate the point. When the tide is high, it is difficult to know whether beaches are sandy or rocky and for many purposes it does not matter. Similarly, when tariffs are high, it does not matter if a country has other trade barriers. As the tide falls, however, there is a big difference between sandy and rocky beaches because the rocks are now visible and affect the use of the beach. Likewise, a country (like the U.S.) which relied primarily on tariffs, finds itself much more open to trade when tariffs fall than a country with lots of hidden barriers that only become visible as tariffs fall.

Finally, the GATT covered primarily industrial goods. It turns out that our comparative advantage appears to lie in other areas, areas that are not covered by GATT, including services and agricultural commodities. For both services and agricultural goods, substantial barriers exist that make it difficult for the U.S. to export to other nations. Thus, while GATT was a success on one dimension, it turns out to be a dimension that matters greatly to those who would export to the U.S. but less to us.

These problems with GATT, the change in our relative economic position vis à vis the rest of the world, and the decline in domestic industries of political importance have created a very different kind of environment than that which existed just after World War II. In addition, large U.S. domestic deficits and flexible exchange rates have provided an easy means for capital flows to the U.S., flows that result in a highly valued dollar in international markets. This highly valued dollar, while accommodating the partial funding of our domestic deficit by foreigners, also makes U.S. goods relatively uncompetitive on international markets, which makes the environment even less hospitable to free or open trade. Thus, protectionism becomes a seductive option to "cure" our ills, and tariffs or non-tariff barriers seem to be the answers.

Tariffs have the nice property that they are reasonably transparent, that is, easy to detect and measure. Non-tariff barriers, like voluntary export restraints entered into by our trading partners, are not as transparent. This makes them, unfortunately, much more attractive in the current environment. I view them with great alarm because they are much more difficult to negotiate away. Their use is a confirmation to some degree of the old law of unintended consequences: GATT reductions in tariffs did not eliminate protectionist pressures, they simply forced those pressures to surface in areas where

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unraveling them would be much more difficult.

Why this alarm? The history of voluntary restraints has not been encouraging. In 1955, in response to threats to impose some sort of import restrictions on the rapidly increasing imports of textiles from Japan, the Japanese government offered to voluntarily limit exports to allow U.S. textile firms to adjust to the new market conditions. The resulting higher price of textiles in the U.S. provided a powerful stimulus for other nations to enter this business, and Hong Kong soon did. Again in response to threats of direct protectionism, the temporary voluntary agreement with the Japanese was extended to Hong Kong. It was then extended to Taiwan, to South Korea, to Indonesia and to every emerging producer of textiles, including the People's Republic of China following then-President Richard Nixon's diplomatic efforts. This "temporary," "voluntary" arrangement was formalized and extended to synthetic as well as natural fabrics in the early 1970s so that 30 years after the initial "temporary" arrangement was made, it remains in place.

Now, in a major effort to tighten these restrictions, the current administration has redefined what is entailed in "fabrication," which has tightened the effective import quotas, and has thus made its foray into medieval philosophy. Only instead of asking how many angels can stand on the head of a pin, the important question now is, "When is a sweater a sweater?" This issue arises because under the textile quota agreement, some countries have quotas for exports to the U.S. but no domestic textile industry. As a consequence, there is an incentive for a textile producing country to ship its textiles to one of these countries for subsequent shipment to the U.S., thereby exceeding its quota but not the quota of the two countries combined. Since this is a bit blatant, what these countries do, instead, is to ship parts of finished clothing—say the back, two fronts, and two sleeves of a sweater—to a country without a domestic textile industry, for instance China to Panama. The parts are then assembled, labeled "Made in . . . ," and shipped to the United States.

Similar voluntary agreements have been made in a number of areas, including specialty steel, automobiles, footwear, and that all-important domestic sector, mushroom production, which is now covered by a voluntary agreement limiting imports. The U.S. is now proceeding to force our trading partners to "voluntarily" limit carbon steel exports to the U.S.

These arrangements are neither "voluntary" nor "temporary" nor "transparent." To illustrate, consider the current war of words with Japan. This battle was initiated by a fairly dramatic increase in the announced exports of Japanese autos to the United States following the expiration of the "voluntary" Japanese arrangement limiting exports to the United States to about 1.8 million cars per year for the past four years. You would think that the expiration of the agreement between the U.S. and Japan would mean just that, that the Japanese were now free to trade in automobiles. Such, of course, was not the case. It is clear that our government and the industries involved expected a continued adherence to the arrangement by the Japanese with at most modest increases in exports to the U.S. The Japanese were still limiting exports, but apparently at higher quotas than was expected, resulting in an increase in exports to the U.S. under a supposedly open trading system that has triggered the recent attacks on Japan.

Voluntary trade agreements are attractive precisely because they are not transparent. They amount to taxes on U.S. citizens and transfers to some U.S. and foreign producers that never appear on any budget document of the U.S. government. Firms simply claim them as revenues from sales.

Because ideology and ideas matter far less in the political arena than political self-interest, I think one has to be quite pessimistic about the future of the open trading system. In fact, the subtle manner in which it is now being undermined makes even tariffs attractive by contrast. What is quite certain, though, is that we have neither a Congress nor a president with any commitment to free trade, only to "fair" trade, and that some of our private industries will continue to benefit from hidden, but nevertheless substantial, taxes on each of our incomes to support their own interests. □

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Protectionism: A Threat to Individual Freedom

by Stephen Lai

The rising protectionist sentiment threatens the consumer's right to choose among competing goods and services. This basic right, along with such civil rights as freedom of speech and religion, must be defended or else the government becomes a threat to all individual liberties.

Protectionism takes several forms, all of which violate consumer freedom of choice. Tariffs are the most frequently cited example. In an effort to save Harley-Davidson, the U.S. recently raised the duty on foreign motorcycles from 4.4 per cent to 49.4 per cent.[1] Along with tariffs, protectionist policies have grown to include import quotas on foreign goods and government subsidies to U.S. industries. Other forms of protection include regulations and standards on foreign imports, and government procurement policies which favor the purchase of domestic products.

Protectionism has its roots in the mercantilist period of the sixteenth to eighteenth centuries. Mercantilist legislation was based on the theory that a nation gains wealth only by exporting its products. This completely overlooks consumers and their needs. In the nineteenth century, the Corn Laws of Great Britain provided a tariff barrier against foreign grains, and caused untold suffering among the poorer masses.

U.S. tariffs originally accounted for 92 per cent of Federal revenue.[2] In more recent years, the percentage has fallen to around 1 per cent.[3] The decline in percentage was caused by an increase in the sources of government revenue, not by a reduction in tariffs. The Smoot-Hawley Tariff Act of 1930 raised U.S. tariff barriers to their highest levels, which provoked foreign retaliation resulting in a disastrous plummet in international commerce. As Ronald Reagan stated, the tariff "helped plunge this nation and the world into a decade of depression and despair."[4]

Currently the textile, steel, shoe, and electronics industries are petitioning the government for protection from foreign imports. U.S. producers also call for raising a protectionist wall against the "flood" of Japanese products and retaliation against Japanese protectionism. The U.S. limits Japanese car imports and still restricts carbon steel imports to one-fifth of the market, because the Japanese subsidize industries such as their machine tool manufacturers and charge a 15 per cent to 20 per cent duty on plywood imports.[5] About 180 trade protection bills are being considered by the House of Representatives, and over 300 in the Senate.[6] With more special-interest legislation interfering with the market, the forgotten consumer pays higher prices for fewer goods.

Protectionism has evolved because of the notion that exports are good and imports are bad. Many people mistakenly believe that every transaction must have a winner and loser, despite the fact that people trade because, in their own eyes at least, each expects to gain. Protectionists therefore advocate a "balance of trade" based upon equal sales to both nations.

Industries argue for protectionist policies to allegedly protect consumers from low-quality foreign items and to insure their employees' jobs. These companies disguise their true purpose of gaining security through the elimination of competition.

Many domestic companies demand trade pro-

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tection because of unfair "underselling" by foreign nations. These arguments are absurd because the very nature of the market is to provide goods at a lower price than the competition. Protectionists then claim that foreigners' trade policies are restrictive and are just cause for retaliation, but such policies serve no purpose other than revenge. While retaliation could result in economic disaster like the Smoot-Hawley Tariff, a nation that chooses not to retaliate provides the consumer with the benefits of free choice, and makes a gesture that helps establish friendly relationships.

Advocates of protectionism overlook the benefits of specialization and comparative advantage. Because resources are scarce, consumers are best served when labor, capital, and raw materials are channeled toward the most productive industries. Trade barriers interrupt this process. As Ludwig von Mises stated, "All that a tariff can achieve is to divert production from those locations in which the output per unit is higher to locations in which it is lower. It does not increase production; it curtails it."[7] The market, and not the government, is the most efficient allocator of resources.

Competition is an incentive to adapt and create new products for the consumer, not an excuse to seek government assistance. Without competition, an industry tends to stagnate. Protectionism creates opportunities for monopolization, where prices can be maintained at artificially high levels. As foreign producers improve their products and decrease their costs, protected domestic industries become ever more dependent upon government aid.

Because protectionism raises prices, it reduces living standards. In the words of Adam Smith, "In every country it always is and must be the interest of the great body of the people to buy whatever they want of those who sell it cheapest."[8]

In 1984, tariffs on Japanese cars cost U.S. consumers an estimated 4.5 billion dollars, while clothing duties cost an estimated 8.5 billion dollars.[9] Even if employment was preserved, each job supposedly saved by protectionism cost consumers an estimated $50,000 to $100,000.[10] The consumer pays higher prices when purchasing protected goods, and loses money that could be spent on other products.

Many protectionists contend that economic self-sufficiency is needed for national defense. This argument, however, does not justify protection of the wool industry or beekeepers. When trade is free, consumers benefit from the products of other nations, and friendship and trust develop. When nations depend on one another for trade, there is little cause for war. As Frederic Bastiat stated, "If goods do not cross frontiers, armies will."[11]

The United States has fought several wars related to trade issues. The Revolutionary War began because Great Britain attempted to control U.S. trade. The U.S. fought the Barbary War from 1800 to 1815 to protest the demand for tribute. The War of 1812 protested the blockade of Europe by Great Britain. Even the Civil War was related to the Southern dislike of the Tariff Act of 1828 and the fear of European retaliation.

It is difficult to assess the total cost of protectionism. But we do know that protectionism reduces consumer choices and raises the prices of protected foreign goods and competing domestic products. In addition, our tax dollars are wasted on protected industries that require government subsidies to stay in business. Finally, government procurement policies waste more money through the purchase of over-priced domestic products which could be bought at less cost from foreign suppliers.

To stop this wasting of scarce resources and the spiraling pattern of government intervention, consumers must recognize that freedom of choice is a basic human right, and demand that it be protected like all other rights. □

1. Charles P. Alexander, "The Tricks of the Trade," *Time*, 7 Oct. 1985, p. 34
2. W. M. Curtiss, *The Tariff Idea* (Irvington-on-Hudson: The Foundation for Economic Education, 1962), p. 35
3. Curtiss, p. 35
4. Richard Alm *et al.*, "Free-Trade Fight," *U.S. News & World Report*, 23 Sept. 1985, p. 49
5. Alexander, p. 34
6. Gene H. Hogberg, "Prepare for Trade War!" *The Plain Truth*, Jan. 1986, p. 3
7. Ludwig von Mises, *Human Action* (New Haven: Yale University Press, 1949), p. 737
8. Henry Hazlitt, *Economics in One Lesson* (New York: Arlington House Publishers, 1979), p. 74
9. Alm *et al.*, p. 49
10. *Ibid.*
11. Curtiss, p. 63

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Protectionism and Agricultural Price Supports

by E.C. Pasour, Jr.

Trade is highly important to U.S. agriculture. In recent years, export sales have represented about one-fourth of the total revenue from sales of U.S. farm products. Consequently, there is widespread concern in the agricultural sector about recent losses in markets for farm exports and about the harmful effects of trade barriers imposed by other countries. Exports of U.S. farm products in fiscal 1986 are expected to be less than $28 billion—down about $16 billion from the record high of $44 billion in 1981.

Although U.S. agriculture is generally considered to be a bastion of free enterprise, the reality is quite different. Our domestic agricultural policy has been a perennial albatross in efforts by the United States to liberalize trade. As shown below, there is an inherent contradiction between domestic price supports and free international trade.[1]

Price Supports and GATT

The General Agreement on Tariffs and Trade (GATT) is a multilateral treaty among more than eighty governments (including the United States) established in 1947 to liberalize and expand trade through negotiated reductions in trade barriers. The conflict between U.S. farm programs and free trade, apparent when GATT was formed, led the United States to insist on special treatment for agricultural products. The incompatibility of current farm programs with an open economy can be traced to farm policies instituted during the Roosevelt New Deal era. The Agricultural Adjustment Act of 1933, as amended, *requires* that the U.S. Government impose quantity restrictions whenever imports would "materially interfere" with the operation of U.S. farm programs.[2] Consequently, agricultural and other "primary products" were not bound in the GATT treaty by the general principles that prohibit import quotas and export subsidies.

It is not difficult to see why price supports for dairy, sugar, peanuts, tobacco, and other U.S. farm products have led to protectionist policies. In recent years, for example, domestic prices of U.S. dairy products frequently have been two to three times world prices. The case of sugar, for which domestic price in mid-1986 was about four times world price, is even more dramatic. Without rigid import controls, consumers would undermine domestic price support programs by substituting lower priced imports for price-supported products including sugar, butter, cheese, and peanuts.

Although GATT permits import restraints for agricultural products, there are limits as to how far countries may legally go in restricting imports to protect domestic farm programs. Not all of the U.S. import restraints on farm products can be explained by the GATT exemption. University of Chicago economist D. Gale Johnson shows that U.S. import restrictions on

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sugar, dairy, peanuts, and beef products clearly have violated the GATT principle that import quotas should not be used to reduce imports by more than the extent to which domestic production is reduced.[3] Therefore, when measured against the touchstone of free trade, United States trade policies as they affect farm products fall short in both the letter and the spirit of the law.

Export Subsidies

GATT exceptions for agricultural products are also made for export subsidies as long as a subsidy does not result in "more than an equitable share of world export trade in that product."[4] Even though U.S. agricultural interests are highly critical of subsidized agricultural exports by other countries, especially by members of the European Economic Community (EEC), the United States continues to subsidize the disposal of surplus farm products under the Public Law (PL) 480 ("Food for Peace") program. For example, about $1.5 billion is budgeted for PL 480 in 1986.

The PL 480 export subsidy program, begun in 1954, was motivated in large measure by the desire to dispose of surplus agricultural products. The program ostensibly has other laudable objectives, including improvement of world diets, promotion of agricultural trade, and "food for peace." Exports of U.S. farm products have been increased through PL 480 over the years in a variety of ways, including donations of commodities, sales for local currencies, and sales at low interest rates.

The Food for Peace program, however, is not the only type of export subsidy affecting U.S. farm products. A new $2 billion "export enhancement program" was launched in 1985 to run through fiscal 1988. The program is to be targeted to markets taken over by competing nations using "unfair trade practices." In addition, in an effort to dispose of government stocks of price-supported products, the 1985 farm bill permits farmers to redeem their price-support loans at less than the amount borrowed—another way of using the public purse to drive down price levels in international markets.[5]

The largest amount of expenditures on export subsidies, however, is reserved for the target price method of price supports. In this price suport system, farmers receive from the government the difference between the market price and the target price of a product as a "deficiency payment." This program permits prices received by U.S. farmers for price-supported products to exceed significantly prices in international markets—a poorly disguised export subsidy. It is estimated that these so called "deficiency payments" will total about $10 billion for the 1986 crop year.

Regardless of type, export subsidies are inconsistent with free trade. In the case of agricultural exports, "food aid that preempts the commercial markets of third-country exporters creates an international trade problem and may in the end be deleterious to the interest not only of the international trading community but even of the recipient country itself."[6]

In view of the United States' history of subsidizing exports, U.S. criticism of similar policies in other countries rings hollow. Current complaints about protectionist trade policies by other countries are especially hypocritical in view of the increase in direct and indirect export subsidies under the new farm bill. Agricultural interests in the United States have long criticized the EEC for its protectionist farm policies. The new farm bill means that the United States can no longer argue that it is less dependent on export subsidies than the Europeans.[7]

It should be no surprise when other countries institute trade restrictions that are similar to those long used by the United States. Moreover, appeals to Japan, members of the EEC, and other countries to open their markets to U.S. products are unlikely to appear credible as long as protectionist policies are maintained for U.S. agricultural products.

In the public debate over trade policies, the United States frequently is depicted as a free trade island located in a sea of agricultural protectionism. The preceding examples show that there is a wide gap between this image and reality. Furthermore, as competitive pressures intensify in markets for farm products throughout the world, it becomes increasingly important to recognize the problems posed by U.S. domestic agricultural policies in liberalizing and expanding trade.

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Implications of Rising Agricultural Productivity

Farm productivity is increasing rapidly throughout much of the world, not only in the United States and the European Economic Community, but also in the developing countries where advances in productivity have been especially pronounced. Dennis Avery, of the U.S. Department of State, finds that during the most recent decade, developing-country farm output rose 38 per cent while that of the developed-country agricultures rose only 15 per cent.[8] As an economic analyst who has followed agricultural progress throughout the world since 1980, Avery concludes that future farm export trade will be "fiercely competitive" throughout the world.[9]

The implications of widespread technological advances in agriculture are straightforward for U.S. farm policy. Rising foreign farm productivity and increasing competition in export markets for U.S. farm products implies a progressively higher price tag for U.S. consumers and taxpayers to maintain current U.S. price support programs. Moreover, to the extent that domestic farm programs raise product prices, they provide an artificial production incentive for farmers in other countries.

The responsiveness of sales to a change in product price generally is higher in international than in domestic markets because there are more close substitutes in world markets. In view of this responsiveness and the importance of exports in the marketing of U.S. farm products, protectionism could mean less revenue for the agricultural sector, even in the short run. Of course, protectionism is harmful to the public at large even when it confers short-run benefits on groups with narrowly focused interests.

Government price support programs for farm products are clearly incompatible with an open economy. It is hypocritical for the United States to criticize other countries for using import controls, export subsidies, and other trade restrictions that this country is also using. The United States acting unilaterally cannot abolish protectionist measures in other countries. Policymakers can, however, make our domestic farm programs consistent with free trade. The phasing out of domestic price supports that raise U.S. prices above the world level is an important first step in reducing trade restraints and in opening up world markets for U.S. products. Price supports not only are inimical to trade, they do not achieve their objective of increasing the long-run profitability of agriculture.[10] Measures to reduce trade barriers, on the other hand, increase both prosperity and the prospects for peace.[11]

The 1985 farm bill represents a continuation of the failed farm policies of the past, rather than a major change in direction. Farmers will be more dependent on government payments than ever before. Economic pressures may yet, however, bring about a reduction in agricultural trade barriers. Increasing competition in markets for U.S. farm products and budget pressures may force U.S. policymakers to do what they have heretofore been unable or unwilling to do—modify our domestic farm policies to make them compatible with the GATT objective of liberalized trade.

The harmful effects of protectionist policies are well known. The amount of damage varies with the type of trade restriction, but the effect of protectionism is always the same. It prevents farmers, other workers, and consumers throughout the world from reaping the benefits that occur when individuals are permitted to engage in those activities in which they are most productive. □

1. Some of the points of this paper are discussed in more detail in the author's paper, "Free Trade's Price" in *Choices*, Second Quarter 1986, pp. 33-35.
2. Kenneth W. Dam, *The GATT: Law and International Economic Organization* (Chicago: The University of Chicago Press, 1970).
3. D. Gale Johnson, "Domestic Agricultural Policy in an International Environment: Effects of other Countries Policies on the United States." *American Journal of Agricultural Economics* 66 (Dec. 1984): pp. 735-744.
4. Kenneth W. Dam, *op. cit.*, p. 142.
5. D. Gale Johnson, "U.S. Joins the Agricultural Subsidy Sinners," *The Wall Street Journal*, May 7, 1986, p. 30.
6. Kenneth W. Dam, *op. cit.*, p. 268.
7. D. Gale Johnson, 1986, *op. cit.*
8. Dennis Avery, "Update on Rising World Farm Output," U.S. Department of State, at the Valley National Bank Agricultural Symposium, Phoenix, Arizona, April 10, 1986, p. 1.
9. *Ibid*, p. 7.
10. D. Gale Johnson, "The Performance of Past Policies: A Critique," Ch. 2 in *Alternative Agricultural and Food Policies and the 1985 Farm Bill*, Gordon C. Rausser and K. R. Farrell (eds.) (Berkeley, Cal.: Giannini Foundation, 1985).
11. Joan Kennedy Taylor (ed.), *Free Trade: The Necessary Foundation for World Peace* (Irvington-on-Hudson, N.Y.: The Foundation for Economic Education, Inc., 1986).

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The Seven Deadly Fallacies of Bad Economics

by John K. Williams

In the sixth century of the Christian era Pope Gregory I, remembered by history as Gregory the Great, listed what became known as the "Seven Deadly Sins." Gregory's listing soon became as popular as the vices listed, and by the Middle Ages any preacher worth his salt had in his traveling bag a sermon, or a series of sermons, expounding the nature and detailing the perils of those Seven Deadly Sins.

It may seem somewhat extravagant to liken bad economic thinking to attitudes and actions which allegedly condemned the soul to hell. Yet economic errors are not to be taken lightly. The errors I call the "seven deadly fallacies of bad economics" can lead and have led to unspeakably destructive consequences. Their seriousness cannot be overstated.

The Fallacy of Forgotten Costs

The first fallacy to be considered might be called "the fallacy of forgotten costs." This fallacy is admirably discussed by Frederic Bastiat in a pamphlet he penned in 1850 entitled, "What Is Seen and What Is Not Seen." Writes Bastiat: "Nothing is more natural than that a nation, after making sure that a great enterprise will profit the community, should have such an enterprise carried out with funds collected from the citizenry. But I lose patience completely . . . when I hear alleged in support of such a resolution this economic fallacy: 'Besides, it is a way of creating jobs for the workers.' "

Continues Bastiat: "The state opens a road, builds a palace, repairs a street, digs a canal: with these projects it gives jobs to certain workers. That is what is seen. But it deprives other workers of employment. That is what is not seen . . . In noting what the state is going to do with the millions of francs voted, do not neglect to note also what the taxpayers would have done—and can no longer do—with these same millions."

These words, written over a century ago, could have been penned yesterday! Today's politicians are still prone to justify their high taxing, high spending policies by pointing to the employment opportunities they thereby create—indeed, Lord Keynes provided such politicians with an entire volume of incantations they can mutter when perpetrating what Bastiat called this "ruinous hoax." Strip away the new terminology, and the old fallacy so castigated by Bastiat is revealed—the deadly fallacy of the forgotten cost.

The full import of this fallacy is concealed if we think of "costs" simply in terms of "prices." A price is merely a cost expressed in monetary terms. It is extremely useful so to ex-

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press a cost, relative money prices being the key to economic calculation.

In truth, however, the "cost" of a good a person acquires or of a service a person enjoys or of an activity in which a person engages signifies whatever that person has spent, surrendered, or forgone in acquiring the good, in availing himself of the service, or in engaging in the activity. The cost to me of purchasing a book may be not acquiring a theater ticket. The cost to me of spending a day in a park may be my not acquiring the income I could have earned from writing. The cost to me of using some land I own to grow wheat may be not using that land to run cattle or grow vegetables. Simply, in considering the cost of acquiring some good or using some service or engaging in some activity, one must consider every thing, activity, and state of affairs surrendered or forgone in opting for one of two or more alternatives. Factors such as comfort, time, ease, anticipated future satisfactions, and the approval of other people may well be involved; indeed, any thing, activity, or state of affairs a person values can enter that person's calculation of costs.

Some extremely significant implications for sound economic thinking follow from this insight. The primary point Bastiat makes, however, should be crystal clear. The good a person chooses is seen and felt and enjoyed; the money surrendered to acquire that good, and alternative uses to which that money could have been put, are by definition not seen and felt and enjoyed, and hence are easily forgotten.

Politicians, to take but one example, can triumphantly point to the jobs they have saved in, say, the textile and clothing industries by the imposition of tariffs. Not so obvious, however, are the costs these tariffs involve. In the absence of the tariffs, men and women may well have preferred to purchase relatively cheap imported clothing for themselves and their children. They would thus have possessed additional cash to spend on goods and services they value, but rank in importance below a certain amount of clothing.

Workers would have been employed to provide these goods and services. Other workers would have been employed to produce whatever goods the overseas suppliers of textiles directly or indirectly accept in exchange for those textiles. Jobs in the textile industry are protected, but at considerable cost: The additional goods and services consumers could have enjoyed had they been able to purchase relatively cheap clothing, and the jobs in the production of these additional goods and services for home-consumption and the goods exchanged, directly or indirectly, for the imported textiles.

Add to that the even more intangible factor of forgone competition, and the forgone innovations and technological improvements that may well have characterized a threatened industry's response to competition. Throw in the reality of the forgone liberty of individuals to exchange goods with whomsoever they please and forgone bonds of interdependence forged between nations. It may be that what is surrendered and forgone is valued by many individuals less than what is realized by the imposition of tariffs, but that is not at the moment the point. The point simply is that what is forgone and surrendered is less visible than what is realized. Thus the ease with which men and women fall for the fallacy of the forgotten cost.

The truth is simple. It is summarized in the proposition, "There's no such thing as a free lunch." Every economic choice we make or politicians make for us has a cost. The cost is not obvious, being the valued opportunities forgone. The beginning of economic wisdom, however, is to keep an eye open for what is not obvious, and thereby avoid the deadly economic fallacy of forgotten costs.

The Fallacy of Misplaced Value

In *Canterbury Tales*, Chaucer's Parson states that the Seven Deadly Sins are "all leashed together." So, it might be suggested, with the seven deadly fallacies of bad economics. They merge and overlap. It could well be claimed that the second fallacy in my list—"the fallacy of misplaced value"—and the first fallacy—"the fallacy of forgotten costs"—belong together. Yet it is useful, I think, to distinguish them.

Many medieval ethicists concerned themselves with what they called "the just price." In so speaking, they were suggesting that the money prices of economic goods should reflect

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the "real" or "objective" value of these goods and services. This "real" value of an economic good was perceived as no less a quality of that good, than, say, the good's weight.

As economic thought developed, a distinction was drawn between the "use value" of a good—the good's usefulness to human beings—and the "exchange value" of the good—the alternative goods and services for which the good might be exchanged. Attention focused, however, upon the "exchange value." What, people asked, determines this value? The most promising answer seemed to be that it derived from the productive resources used in its manufacture, labor being the most significant. Thus Adam Smith in his *Wealth of Nations* wrote that, "If among a nation of hunters . . . it usually costs twice the labor to kill a beaver which it costs to kill a deer, one beaver should exchange for or be worth two deer." David Ricardo built on this foundation, and later Karl Marx, greatly indebted to Ricardo, developed his version—some would say versions—of the labor theory of value. The value of an economic good derived, insisted Marx, from only one of the productive resources embodied in that good: the "socially necessary labor time" its production involved.

In 1871, however, a radical challenge to this way of thinking appeared in the form of Carl Menger's *Principles of Economics*. Menger insisted that the idea of "value" was crucial in economics, but he went on to argue that the value of an economic good was not a mysterious quality inhering in the good. Rather, when speaking of economic value one is referring to the relationship between an appraising mind and an object appraised. Value is invariably "value to someone." Value, in other words, is subjective, varying from person to person, from time to time, and from situation to situation. Locating that value in a good rather than in the mind appraising that good is what I signify by "the fallacy of misplaced value."

One distinction must be noted. In determining the value to me of, say, a book, I am ranking the book in relation to other goods on my own value scale. I rank it, let us say, above a theater ticket, and thus acquire the book at the cost of a forgone opportunity to acquire a theater ticket. I might also, however, appraise the purchasing power of a good—that is, estimate how much that good could be sold for. On this matter I can be correct or incorrect. Something "objective" is involved. Yet appraised purchasing power itself rests upon the countless subjective evaluations of my fellow market participants. It is from these hundreds of thousands of subjective evaluations that changing relative money prices in the market are born.

Elaborating how market prices—including the prices of the factors of production—derive from the subjective evaluations of market participants is a fascinating exercise. Linking the subjectivity of value to an understanding of costs in terms of forgone opportunities leads to some extraordinarily significant conclusions.

We are forced, for example, to assert that the cost of an economic choice—be it that of purchasing a book at the cost of the forgone opportunity to procure a theater ticket, or of producing jump ropes at the cost of the forgone opportunity of using the same productive resources in producing clotheslines—is known only to the person or group of people making the choice. We are further forced to insist that an objective measure of cost is simply not available, the individual's evaluation of a forgone opportunity being by its very nature subjective. If this be granted, talk of "social costs" becomes suspect, to put it gently.

No less fascinating is the study of the attempts of many economists to avoid these conclusions, perhaps the most significant of these being Alfred Marshall's tortuous synthesis, which featured a productive resource theory of cost on the supply side and a subjectivist analysis of cost on the demand side.

Suffice, however, that we be aware of the fallacy of misplaced value. When we hear Marxists darkly muttering of the "surplus value" expropriated by capitalists, or other economists speaking as though they could objectively compare the "value" of one distribution of economic goods to that of an alternative distribution, we should become suspicious.

The realization that all economic choices involve costs can lead, by a faulty leap of logic, to two further deadly economic fallacies that typically come together: "the fallacy of static wealth" and "the fallacy of the zero-sum game."

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The Fallacy of Static Wealth and the Fallacy of the Zero-Sum Game

These twin fallacies take the form of a sort of picture dominating the thinking of many people. Economic activity is depicted in terms of a poker game. One player's chips are observed to have increased. Immediately one concludes that some other player has lost chips. Poker is, as they say, a zero-sum game: Gains enjoyed by one party must be balanced by losses suffered by another. So it is, people embracing the fallacies of "static wealth" and "the zero-sum game" insist, with economic exchanges. "Winners" must be balanced by corresponding "losers."

Such was the "picture" held by advocates of the socio-economic system known as mercantilism, the system Adam Smith so vigorously attacked. Perhaps the word "system" is somewhat misleading, for, as Thomas Sowell has noted, "[mercantilism] is a sweeping label covering a wide range of writings, laws, and policies beginning in various European nation-states in the seventeenth century, still pervasive in the eighteenth century, and never completely extinguished till the present day." ("Adam Smith in Theory and Practice," in *Adam Smith and Modern Political Economy,* edited by Gerald P. O'Driscoll [Ames, Iowa: The Iowa State University Press, 1979] pp. 3-18) Yet crucial to the thinking of "the motley collection of businessmen, pamphleteers, and politicians" described as "mercantilists" was the perception of wealth as something static and of economies as zero-sum games.

According to the mercantilists, wealth was a constant, a given—like the chips in a poker game. If one community—and typically the mercantilists thought in terms of communities—improved its overall economic situation, another community must have lost out. That losing community, so it was claimed, must have bought more goods from the winning community than it had sold to that community, the difference having been made up in gold. As the seventeenth-century writer Thomas Mun expressed it, only "the treasure which is brought to the realm by the ballance [sic] of our foreign trade . . . [constitutes the amount] by which we are enriched" *(England's Treasure by Forraign Trade* [1664; New York: Kelley, 1965] p. 21). To achieve an export surplus, mercantilist nations were characterized by governmental controls of a magnitude and scope which, as Sowell puts is, "probably exceeded anything seen in the twentieth century, either in capitalist economies or in most socialist economies" *(ibid.*, p. 4).

What Adam Smith perceived, essentially, was first that "wealth" was not something static and given like gold, or, indeed, poker chips, but rather consisted of goods and services that could be created, and second that both parties to an economic exchange could improve their respective situations. This second perception is sharpened if we take seriously the truth ignored by those committing the fallacy of misplaced cost, namely, that the value of an economic good is not a mysterious quality somehow residing in the good but a relationship between an appraising mind and some object appraised.

If, in the absence of coercion, two individuals exchange goods or services, it can be only because each party to the exchange values, at least at the time of the exchange, what is obtained more than what is surrendered. Each anticipates enjoying a more valued situation by making the exchange than obtained before making the exchange. There are two winners, not one. This is a positive-sum, rather than a zero-sum game.

Given that Adam Smith in 1776 exposed the twin fallacies—the fallacy of static wealth and the fallacy of the zero-sum game—and given the clinching of this exposure by the insistence of economists following the lead of Carl Menger that the "value" of a good or service signifies the value of that good or service to someone, one might have thought that the two fallacies could be exorcised from people's thinking. But not so.

Consider the following statement, taken from the published sermons of a cleric with whom I am fighting a somewhat protracted battle:

"Think of an economic system in terms of some castaways on a desert island. The castaways have brought with them some fresh water, and they find a supply of bananas and coconuts on the island. Some of the castaways have

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greedily claimed that they own the water and the supply of food. They feast, but their fellow castaways starve. Some suffer, simply because others are selfish."

The key phrase in this: "Think of an economic system as . . ." The speaker is describing a static situation: an island with a given supply of food and water. And that is precisely how *not* to think of an economic system!

If an economic system is to be compared to an island, let it be a large island inhabited by active people. Some people have devised a way of distilling fresh water from sea water. Some have established banana and coconut plantations. Some have become skilled at fishing. Some have bred wild goats. Some have learned to extract iron. Even the simplest are contributing to the process of wealth creation, say by tending a fire used for the distilling of water. The moment one starts thinking not in terms of goods simply provided like manna in the wilderness, but of men and women using the skills and imagination they possess and the raw materials at their disposal to create the goods and services they want, one is beginning to approach the reality of an economic system. And one has escaped from the deadly economic fallacy of finite wealth.

Consider another quotation from the same source:

"One does not have to be a genius to realize that, if some citizens in western nations are getting richer, then other citizens of these nations—or perhaps men, women and children of the Third World—are getting poorer. One does not have to enjoy a university education to realize that, behind newspaper headlines reporting company profits, are the many helpless little people who have been forced to endure losses. If Peter prospers, somewhere there's a Paul Peter has robbed."

Frankly, one does not have to be the possessor of a university education to realize that the author of these passages is peddling the discredited economic nostrums of yesteryear. He has embraced, and is luring his listeners and readers to embrace, the twin fallacies under consideration: the fallacy of static wealth and the fallacy of the zero-sum game.

In all fairness, I should add one qualifier. The fallacy of the zero-sum game is only a fallacy if the exchanges made by people are not coerced. The moment coercion enters the picture—be that coercion exercised by individuals who have discovered that improving their well-being by plunder is more congenial than doing so by production and voluntary exchange, or by governments using their coercive power for purposes other than the protection of citizens from such individually initiated coercion—then zero- and indeed negative-sum games abound. Sadly, however, few of those depicting economic activity in terms of zero-sum games are advocating the only economic system which avoids such "games"—the free market.

The Fallacy of False Collectives

The fifth deadly economic fallacy I would bring to your attention is the fallacy of false collectives. All of us are familiar with collective nouns: "the community," "the state," "a society," "the working class," "aggregate demand," and even "the market." These terms can be extremely useful, functioning as a sort of shorthand whereby we refer to numerous individual human beings and particular relationships between them. Problems are created, however, when we start speaking and thinking as though these terms signify "thing-like," existing entities distinct from these individuals and relationships.

There may be some value, for example, in occasionally using such terms as "aggregate demand" and "aggregate supply." Mischief is afoot, however, when the real world that economics seeks to understand—the world of people seeking to improve their situations by using what they have to acquire what they want—is supplanted by a purely imaginary world, a sort of ballet called "the economy" starring the two dancers "aggregate demand" and "aggregate supply." Lost in that imaginary world one is tempted to get into the act, so to speak.

Why not play choreographer? Why not improve the performance by stimulating "aggregate demand"? There is nothing wrong with this fantasy if fantasy it remains, but when the real world of economic activity is subjected to governmental activities described as "stimulating aggregate demand," disaster can result.

Indeed, there are dangers inherent in aggre-

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gates even if one avoids the fallacy of treating these aggregates as concrete "things." As Madsen Pirie observes in *The Logic of Economics* (London: The Adam Smith Institute, 1982), "When we use numbers we lose information." A study of "apples" dictates indifference to information about the particular weight, shape, taste, and so on of each component apple; a study of "fruit" dictates indifference to further detailed information. Yet in economics, as is the case elsewhere, truth often lies in the details.

Suppose we are thinking of the phenomenon of involuntary unemployment. We are wondering if the phenomenon is related to wage rates. We do our homework. We reach a fairly general conclusion: If men and women are to use what they have to acquire what they want, they must direct their productive efforts in a way that takes account of the changing tastes and preferences of their fellows, the changing skills and technologies available to a community, the changing relative scarcities of raw materials distributed globally, and so on. We further conclude that information about such realities is available only when it is encoded in changing relative money prices in a free market.

We note, for example, that a rise in the price of one product relative to others tells both consumers and producers what they must do to improve their situations, and constitutes an incentive for these people to act. We finally conclude that changes in the prices for various forms of labor in various activities encode the best information available in a large and complex society for what we might call the "distribution" of labor.

A downward move in the wage level available for people of certain skills in a particular industry, and an upward move in the wage level available for people of different skills in another industry, "informs" people as to what skills it is desirable to acquire and in what industry it is desirable to seek employment. We thus conclude, perhaps, that politically determined or sanctioned measures preventing wage rates from moving downward in certain industries or arbitrarily forcing them upward in other industries deprive people of the information they need if some sort of correspondence is to obtain between the distribution of various forms and quantities of labor and the distribution of demand for these forms and quantities of labor.

Suppose, however, that we attempted to tackle the problem, thinking only of some abstraction called the "unemployment rate" and the "average wage level." There is no way that, so thinking, we would find ourselves looking askance at measures interfering with changes in relative wage rates. Inevitably, economic theorists and politicians embracing the fallacy of false collectives are destined to lead men and women to economic disaster.

The Fallacy of Centralized Planning

The sixth deadly economic fallacy I have called "the fallacy of centralized planning."

The defining economic question can, perhaps, be expressed thus: "How are men and women to use what they have—skills, raw materials, information, and time—peacefully to acquire what they want?"

Some components of an answer are reasonably apparent. For example, the adverb "peacefully," which precludes an answer to the question in terms of the oldest labor-saving device known to humanity—the use of violence to expropriate desired goods from men and women creating these goods—demands, I suggest, some adopted practices or accepted institutions protecting people from coercive violence. Any response to the question which goes beyond the most primitive will involve, I submit, at least a rudimentary division of labor. But the activity I particularly wish to focus upon is that of coordination.

Historically, human beings have discovered but three ways to coordinate their productive efforts so that they more or less successfully use what they have to acquire what they want: coordination by tradition, coordination by political edict, and coordination by "the market"—and I am aware, incidentally, that this term "the market" is itself an abstraction or collective of sorts, pointing to individual men and women enjoying private property rights and voluntarily engaging in transactions chosen and negotiated by themselves.

Tradition is a satisfactory means of economic coordination—"planning" if you like—only for

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the most primitive and static of societies. The two options today deemed viable for large and complex societies are those of coordination by political edict and coordination by the market—the "command economy" and the "market economy."

The fallacy of centralized planning has it that while in simpler times it may have been possible to coordinate the economic activities of men and women by the market, the complexity and rapid technological changes of today's world make such a means of coordination impossible. It is claimed that we thus require expert planners working in conjunction with politicians.

I submit that this claim is a fallacy reversing the reality. Only the market can coordinate the economic activities of hundreds of millions of men and women in a rapidly changing world.

Consider, for a moment, a simple tribal society. Assume that the wants of its members are limited, the skills possessed by the "tribe-as-a-whole" are relatively few, and the raw materials available to the tribe remain more or less the same from year to year. In such a situation we can imagine tribal elders, or even the tribe as a whole, meeting and planning the tribe's economic activities by reference to this readily available information about what the tribe "has" and what tribe members want.

Now consider, in contrast, a large and complex society. A vast menu of possible wants is available, individuals opting for widely different "lists" of wants and diverse rank orderings of these wants. Skills are highly specialized and are diffused through millions of people, and constantly change as new technologies become available. Resources are distributed globally, and are marked by constantly changing relative scarcities. It is literally impossible for political planners, however good and wise, to collate, synthesize, and make economic decisions by reference to this totality of information.

Yet as already noted, this information is available, in an appropriately distilled form, in a market economy. Changing relative money prices, which are determined by the interactions of millions of individuals seeking to improve their situations through what they produce and the voluntary exchanges they make, "encode" this data. There is planning and coordination, but it is the planning of countless individuals doing what they can to acquire what they want, and the coordination of these plans by what Carl Menger called the "organic phenomenon" of the market or what Friedrich Hayek called the "spontaneous order" of the market. The very complexity of modern societies, and the diffused, changing, and essentially private nature of much of the information which coordinated economic activity must utilize, combine to make central planning impossible.

It is tempting to suggest that this sixth deadly fallacy of bad economics is rooted in the first of the old Seven Deadly Sins: the sin of pride. It is humbling to acknowledge that the peaceful activities of the many can coordinate an economy with a subtlety and flexibility the deliberative planning of a super intelligent few could never realize. Perhaps it is this very pride that makes the deadly fallacy of centralized planning so attractive.

The Fallacy of Market Mastery

The seventh and final deadly economic fallacy to which I would draw your attention I have called "the fallacy of market mastery." This is the fallacy of those who claim that the market is a means whereby some people exercise power over others.

Consider, for example, this frequently heard statement about labor unions: "Were it not for unions, employers could set whatever wages they wished. Their economic power would be absolute!"

The model is clear. Capitalists allegedly enjoy power over those with only their labor to sell. The whim of employers would determine wages were it not for the bargaining power of unions—a power dependent upon the capacity of unions to prevent workers from accepting a wage lower than the "union wage."

This claim could well lead us into an examination of a range of theories explaining how wages are determined: the subsistence theory of Malthus and Ricardo, the wage-fund theory of John Stuart Mill, and so on. Let us content ourselves, however, with briefly returning for a moment to the days of mercantilism—in particular, mercantilist France.

Unions as such did not exist. The government actually imposed *maximum* wage laws. Any

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employer who paid wages above a legally defined ceiling was charged with an economic crime, tried, and if found guilty, may well have been sent off to be chained to an oar in one of France's sea-going galleys. The shocker is that numerous employers defied these maximum wage laws!

Why? The selfishness of employers, and the forces of even a grotesquely fettered market, led them to engage in their law-defying activities.

Suppose, for example, I am a factory owner in mercantilist France. By taking on an additional worker I can increase the hourly output of my factory by goods I can sell for $40. The money costs of the raw materials involved in producing these additional goods, and the money costs of the additional wear and tear on my machinery, come, let us say, to $20. The maximum wage rate the government allows me to pay each worker is $1. Each additional worker I can put on thus yields me an additional $19 an hour!

Now for the purposes of our discussion, let us assume the same figures apply in all industries. Each additional worker an employer takes on represents an additional $19 in the employer's pocket. But to acquire my additional worker, I have to attract him from his present employment. To do that, I must content myself with, say, an extra $18.50 an hour I can pocket, offering him not $1 an hour but $1.50 an hour.

Simply stated, employers must bid for a worker's services. In this hypothetical situation, the critical figure is $20 an hour. At any wage rate below that figure, employers benefit by adding employees. At any wage rate above that figure, it doesn't pay to add an additional employee—hence the damage caused by minimum wage laws. Wage rates tend toward the money value of the productive output of labor, and that is increased as the capital invested per worker increases.

The economic system in mercantilist France was anything but a free market. Yet such rudimentary and fettered aspects of the market as did exist were sufficient to generate what we might call "the mystery of the inexplicably generous employers." Simply put, the market itself—the self-directed productive and exchange activities of individual market participants—determines wage rates, just as it determines all prices. Indeed, in an unfettered market economy, the profits of the entrepreneur, the interest accruing to the owners of capital and land, and the wages of workers, are all determined in this sort of way. They reflect the relative contributions of the entrepreneur, of the owners of capital and land, and of those selling their labor, to the productive process. That is the genius and, indeed, the beauty of the market.

For our purposes, however, it is sufficient to stress that given a market economy—and that entails the rule of general principles of conduct equally applicable to all proscribing the use of violence or threatened violence by any—the price for which individuals can sell their labor is set by the same process all prices are set, a process of competitive bidding for scarce resources and goods. No person or group of people exercises mastery over the market or is in a position arbitrarily to control the price of anything. All that anyone can do is to offer to exchange goods and services with his or her fellows.

Conclusion

Men and women once took the Seven Deadly Sins with desperate seriousness. Pride, envy, anger, sloth, covetousness, gluttony, lust: the list was familiar. Preachers, and writers such as Chaucer and Dante, depicted in considerable detail the dire consequences of actions informed by these realities.

I have referred to seven fallacies. The fallacy of the forgotten cost. The fallacy of misplaced value. The fallacy of finite wealth. The fallacy of the zero-sum game. The fallacy of false collectives. The fallacy of centralized planning. The fallacy of market mastery. There is no need for me to depict the dire consequences of actions informed by these fallacies. They are familiar to all who contemplate human history, both ancient and contemporary. Familiar also, however, are the consequences for a people who seek to use what they have to acquire what they want in ways rooted and grounded not in these fallacies but in economic truth. May the liberty and the plenty that such truth alone makes possible be enjoyed by ourselves, by our children, and by our children's children! □

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Freedom and Failure

by Dwight R. Lee

During good times and bad, the economic landscape seems always littered with firms that have failed, workers who have become unemployed, farmers who have lost their land, and the residue of entire industries in the process of withering away. The natural tendency is to see these failures, and the genuine human hardships that result, as a flaw of the economic system that produces them. Even those who consider themselves supporters of the market economy call for government action to buffer society against the harsh failures of unfettered capitalism.

It is certainly the case that when viewed in isolation the consequences of economic failure appear cruel, harsh, and unfair. Because of events over which they have little or no control, many hard-working, law-abiding citizens experience serious economic hardships in a system of free market capitalism. No one can argue with credibility that all, or even a significant minority, of these victims of economic failure are getting what they deserve in any particular instance of adversity. But economic outcomes that in isolation seem unjustified may be the necessary consequence of a system that is generating an overall, long-run pattern of outcomes that is entirely justified. As Henry Hazlitt has warned repeatedly, the major source of error in economic understanding comes from the tendency "to concentrate on . . . short-run effects on special groups and to ignore . . . the long-run effects on the community as a whole."[1]

Hazlitt's warning cannot be overemphasized when considering economic failure and the fairness of free market capitalism. Each market failure is an inseparable part of a wider web of interactions and outcomes that provides everyone the maximum opportunity for success in the world of scarcity. Scarcity is an unfortunate fact of life, and it is easy to see scarcity itself as unfair. But unless one is prepared to argue that making the best of an unfortunate situation is also unfair, there can be nothing unfair about free market capitalism. And because instances of failure are necessary companions to the general success of the free market process, it would require a sharp twist of logic to characterize as unfair the failures that arise from free market activity.

Economic failure is inevitable if we are to have economic progress. One explanation for this link between failure and progress was provided by Joseph Schumpeter when he described capitalism as a "process of creative destruction."[2] The discovery of improved products, and better ways of producing existing products, necessarily means that many established products and technologies are valued less. Those who have committed their resources to these now obsolete products and technologies will suffer a decline in wealth as their investments turn sour and their skills become less employable. They will experience economic failure. But this destruction of wealth, or economic failure, is only part of a larger picture of wealth

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creation and economic success. The loss of wealth experienced by some is (1) a transfer of resources to those who will put them to more valuable use, and (2) a compelling incentive to redirect efforts into more productive employment. The process of "creative destruction" is our best hope for economic success.

Entrepreneurial Freedom and Failure

There is another vital link between economic failure and progress. Economic progress that expands opportunities for all is clearly a force for fairness. Such broad-based economic progress depends on what is best described as the entrepreneurial spirit. Without those with visions of what might be, and the dedication and courage to pursue those visions, few of the technologies and products that provide the foundation for our current wealth would be available. It is only because individual entrepreneurs have had the freedom to attempt what the more "sensible" among us would never have attempted that economic development has been possible.[3]

This does not mean that most entrepreneurial ventures contribute to our economic well-being. Quite the opposite is true. A relatively small percentage of the projects promoted by entrepreneurs add more to our wealth than they consume in time, talent, and resources. Most entrepreneurial ventures turn out to be exactly what most of us would have predicted in advance—impractical fantasies. But, it is impossible to know in advance which entrepreneurial gambles will be an economic step forward. There is only one way to discover these economic successes, and that is by giving entrepreneurs the freedom to snub their noses at the conventional wisdom and venture forth in pursuit of their "impossible" dreams.

This freedom to attempt success in the face of daunting odds requires an accompanying freedom to fail. And the freedom to fail has to be sufficiently painful that it cannot be ignored. The entrepreneur whose project is rejected by the consumer will remain convinced that it is the consumer who is mistaken. Unless such entrepreneurial confidence is sternly subordinated to consumer preferences, the losses from the many entrepreneurial mistakes would persist and overwhelm the gains from the relatively few entrepreneurial successes. Without the discipline of failure forcing accountability to consumer preferences, entrepreneurial ventures would be economically destructive and entrepreneurial freedom could not be tolerated. The economic system that cannot condone failure cannot risk freedom.

Communication, Honesty, and Concern

There is only one economic system that turns failure into a force for the type of accountability that makes freedom possible. That system is free market capitalism. It is a system that allows freedom because it is a system that motivates people, both when they succeed and when they fail, to deal with each other with honesty and fairness.

Consider the characteristics of a system of human interaction that would be ideal from the perspective of economic accountability and fairness. First, this system would have each of us in constant communication with everyone else. If there is to be any hope of being accountable to the preferences of others in our use of resources, each of us will need to receive information from others on their preferences. Second, the communication that took place would be honest. Transmitting inaccurate information on the value derived from resources would make it impossible to direct resources into their highest valued uses. Third, each individual would give the preferences of others the same weight he gives his own. No matter how much an individual may desire one economic outcome, if others communicate to him that they value another outcome even more he would accommodate their preferences.

It is possible to achieve a real world approximation to this ideal system—free market capitalism. The key to understanding this approximation is in recognizing the incentives established by the private property system which forms the foundation of the market.

In the private property system, resources are transferred from one individual to another through voluntary exchanges. The market prices that arise from these exchanges are the

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means by which all market participants communicate their preferences to each other. There exist strong incentives for people to communicate honestly through prices. It is in the interest of all market participants to assess carefully the value realized from different resources, and to communicate their desire for more of a particular resource only if it is honestly worth more to them than the prevailing market price. The temptation sellers would otherwise have to overstate the values of their products with excessive prices is controlled by market competition.

Finally, each market participant is motivated to act *as if* he has the same concern for the preferences of others as he has for his own. When an individual reduces his use of a product in response to a higher price, he is in effect saying, "Others are telling me that this product is worth more to them than it is to me, so I will consume less so that they can consume more." Similarly, economic failures such as bankruptcies and unemployment can be thought of as people saying, "Others are telling me that my resources would be more valuable in other activities, so I will respond to their preferences." These "failures" reflect the success of free market capitalism in getting people to cooperate with each other freely, fairly, and honestly.

Focusing on Failure

Unfortunately, few people heed Henry Hazlitt's warning and look beyond the isolated trees of economic failure to see the overall forest of economic success. This oversight is explained in part by the fact that it is easier to concentrate on particular outcomes than to comprehend the larger pattern of which these outcomes are only a part. But this is far from a complete explanation. The fact is that there is more for people to gain as members of organized interest groups by concentrating on the isolated failures than by considering the overall success of free market capitalism.

When individuals suffer losses from the operation of free market capitalism, they are in fact making a necessary contribution to the working of an economic system that serves the long-run interest of all. From the perspective of each individual, however, the best possible situation would be to receive protection against personal economic failure while benefiting from the contributions the failures of others make to economic progress. The fundamental fairness of the free market is that it does not provide anyone a free ride on the contributions of others. In the free market everyone has to contribute to the general economic prosperity by accepting the failures as well as the successes that come his way.

It is the legitimate function of government to enforce the private property rights upon which the fair and honest cooperation of the free market depends. When property rights are enforced no one can avoid making the cooperative adjustments required by economic failure while benefiting from the cooperative adjustments economic failures force on others.

Unfortunately, government power, though justified as a means of protecting property rights, can be destructive of these rights. This abuse of government power is sure to occur when, as has been the case in recent decades, government ceases to be viewed as a necessary evil and instead is seen as the primary source of social progress. Once it becomes widely believed that the discretionary use of government power is an acceptable means of solving particular economic problems, economic failure will become a useful justification for the politically organized to receive unfair advantages at the expense of the politically unorganized.

The negative consequences of economic failure are highly visible because at any one time they tend to be concentrated on a relatively few. The positive consequences of economic failure are largely invisible because they are indirect and spread over the entire population. When the few who experience economic failure are organized they will see it to their advantage to lobby government for relief. By granting this relief, politicians receive the gratitude of the benefiting few by imposing a diffused cost on the entire population. This imparts a clear political bias in favor of substituting unfair government force for the fairness of market cooperation. This bias, however, although generated by the political muscle of organized special interests, ultimately rests on perceptions of fairness.

If protecting a particular group against the consequences of economic failure is widely

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considered to be an unjust use of government power, then politicians will be very reluctant to provide such protection. Special interest groups lobbying government for relief from an economic failure cannot rely solely on the organizational advantage they have over the general public. Success depends crucially on the perception that justice is served by indemnifying particular groups against failure. There is much to be gained by those that are, or would be, politically influential from portraying their economic failures as unfair. No one should be surprised that as government has grown, the focus on economic failures has increased, as has the perception that these failures are unfair. With government standing ready to transfer wealth to those whom the economy has treated "unfairly," the private payoff is increasingly in lamenting the "unfairness" of failure rather than celebrating the fairness of the cooperation, wealth, and freedom that this failure makes possible.

Conclusion

The fact is that government cannot reduce economic failure. It can only protect some against failure by increasing the overall level of failure and imposing it on others. As Hayek warned over 40 years ago: "The more we try to provide full security by interfering with the market system, the greater the insecurity becomes; and, what is worse, the greater becomes the contrast between the security of those to whom it is granted as a privilege and the ever increasing insecurity of the underprivileged."[4]

The special favors granted by government are not only unfair, they become the justification for yet more futile government attempts to provide security against economic failure.

Once government starts down the road of buffering people against the failures of market activity it becomes difficult to turn back. And the ultimate destination if we remain on this road is a politicized economy lacking both fairness and prosperity because it cannot provide the accountability nor tolerate the freedom which are essential for economic success and honest cooperation. The best hope for preserving the market process is by advancing public understanding of how this process works to promote a broad-based prosperity. Only through economic understanding can we pierce the rhetorical facade of fairness used by organized special interests to acquire political favors. Once this facade has been stripped away, it will be difficult for political opportunists to undermine the freedom and prosperity of all under the pretense of concern and justice. □

1. Henry Hazlitt, *Economics in One Lesson*, New York, Arlington House Publishers, 1979; p. 17.
2. Joseph A. Schumpeter, *Capitalism, Socialism and Democracy*, New York, Harper Torch Books, 1962; pp. 81-86.
3. The benefits from freedom are clearly not confined to those who choose to exercise it. As F. A. Hayek has said, "The benefits I derive from freedom are thus largely the result of the uses of freedom by others, and mostly of those uses of freedom that I could never avail myself of. It is therefore not necessarily freedom that I can exercise myself that is most important for me." See F. A. Hayek, *The Constitution of Liberty*, The University of Chicago Press, 1960; p. 32.
4. F. A. Hayek, *The Road to Serfdom*, The University of Chicago Press, 1944; p. 130.

Subsidizing Inefficiency

IDEAS ON LIBERTY

BECAUSE FAILURE is repugnant to a welfare-oriented society, we see continued efforts made to put a floor under everything. This includes a spreading attempt to bolster up faltering business firms or even whole areas or industries by government grants, loans, subsidies, defense contracts, and the like.

Ironically, the greatest danger to our economic system today lies not in a direct attack on profits, but in a well-meaning effort to insure everyone against failure. To put it bluntly, this means subsidizing inefficiency; it is the antithesis of the effective operation of the profit motive.

We are in danger of losing one of our greatest freedoms: the freedom to fail. Profit and loss are two sides of the same coin; take away one side and you take away the whole coin. Our greatest economic asset is the right to invest private capital in the hope of making a profit, but at the risk of losing our shirt.

—GEORGE CLINE SMITH

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A REVIEWER'S NOTEBOOK

The Start-Up Entrepreneur

by John Chamberlain

In his *Discovery and the Capitalist Process*, which was reviewed in *The Freeman* last winter, Israel Kirzner speaks of three levels of entrepreneurial endeavor. One is at the level of arbitrage, where paired buying and selling transactions are simultaneous. A second level of entrepreneurship is pure speculation on the future. This depends on alertness but without any simultaneity in the buying and selling of physically identical objects. The third level in Kirzner's triad is that of productive creativity in which the entrepreneur sees possibilities in novel forms of combination.

Though the Kirzner levels may overlap in gifted individuals, a case can be made that only the third Kirzner type of operator deserves to be called the true entrepreneur. The arbitrage dealer creates nothing by his trades as such, though he may use his profits creatively at a different time. The pure speculator may help his own bank account to grow, but it will be the bank's business to use the speculator's profits creatively. In his *The Start-Up Entrepreneur* (New York, E. P. Dutton, 306 pp., $18.95) James R. Cook pays his respects to all types of enterprisers, including managers such as Alfred P. Sloan of General Motors who also had creative flair. But for the most part Cook is concerned with people who, perceiving market gaps and unsatisfied wants, bring improved or new products and services into existence.

There is a strong autobiographical thread to Mr. Cook's book. He had been a small-town insurance agent in Minnesota, but he yearned to start a manufacturing and servicing company of his own. Without doing any research whatsoever in the field of water purification he plunked down some of the cash he had received from selling his insurance agency for a franchise to market "Crest Water" in the Miami-Fort Lauderdale area of Florida. The Crest Water machine that went with the franchise could really do a purifying job, but it soon became apparent that Cook and his partner Jay Anderson didn't know Florida. They thought they could sell to the restaurants. After a score of turn-downs and some unfortunate encounters with antagonistic Health Department inspectors they decided to concentrate on condominiums and apartments. When they finally made several inroads in North Miami, they discovered that the machines they sold rusted within weeks. And there was a fish taste when the deionization tanks wore out.

There had to be corrections in the machines. Before the manufacturers came through with something workable the problem of getting customers remained acute. Luckily Cook and his partner got a tip that the thoroughbred horses at the Tropical Park race track were drinking bottled water. Cook's partner made the rounds of the trainers, and in a few days he had a life-saving order. After further trials and tribulations Cook found a Key Biscayne developer who was willing to test a coin-operated machine in one of his flagship buildings. The coin-operated concept proved the breakthrough. There were still other difficulties, both of money-raising and manufacture, to survive, and the business never did become a gold mine. But

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fourteen months after they had started Cook and his partner found someone to buy their business for $120,000.

What Cook learned from his Florida experience was persistence. Back home again in Minnesota he began to keep a notebook compilation of "needs" and "errors." As a gun collector he noticed there was no market price guide for prospective gun purchasers. So he began to publish the *Blue Book of Gun Values*. He formed a group to offer insurance on safe deposit boxes after he had gone into the business of selling gold and silver to investors. Market gaps seemed to open up everywhere. He put up the capital to help start a company that sold nonalcoholic mouthwash to members of Alcoholics Anonymous. The company — Morning Magic Mouthwash of Colorado — is still prospering. During the oil crisis he beat a formidable competitor in providing wood stoves. The market gap here lasted all too short a time, but, with his Investment Rarities Incorporated, which does a lot more than buy and sell precious metals, Cook has never been at a loss for new diversified entrepreneurial ventures.

As a "how to" book as well as an autobiography *The Start-Up Entrepreneur* is filled with all sorts of valuable advice to beginners. The problem of diversification must be handled carefully. Oddly, investment capital for small enterprises never seems to depend on interest rates. If the "cut in" prospects seem good to friends and relatives of small-time enterprisers, the money comes through. This probably explains why the vast increase in jobs under Reagan has come from small companies that have not had to borrow at particularly high interest rates.

Much of Cook's advice comes in the form of quotations from the famous entrepreneurs and free market thinkers of both past and present history. Ray Kroc of McDonald's is quoted so often that he might well have been listed as a co-author. In certain sections the book reads like an anthology, with wisdom coming in short and effective spurts from Andrew Carnegie, Peter Drucker, Cyrus McCormick, J. C. Penney, Napoleon Hill, Ludwig von Mises, Leonard Read, Conrad Hilton, Henry Ford, Stanley Marcus, George Gilder, and Dale Carnegie, just to name a few of Cook's chosen mentors.

Cook seems to have done superlatively well for himself despite government regulation and the depredations of the Internal Revenue Service. He is always mindful, however, that he might have started more businesses if the State had not asked for half his profits. He surmises that if Thomas Edison had been bothered with modern taxation he would have failed to carry through on half his inventions. The paperwork involved in keeping track of the many Edison false starts would have driven the man crazy. □

MONEY AND FREEDOM

by Hans F. Sennholz

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Reviewed by Richard A. White

Money is the most marketable economic good in society. Individuals attach value to money with the future expectation of obtaining with it goods and services in the market; money is valuable because of its purchasing power. Money facilitates exchange and makes possible an advanced division of labor.

Since the creation of the Federal Reserve System in 1913, the federal government has enjoyed a money monopoly. The government, which controls the Federal Reserve, may inflate the currency seemingly at will, since legal tender laws force individuals to accept the state's devalued money.

But inflation has dire consequences. As Professor Hans F. Sennholz points out in his latest, provocative book, *Money and Freedom*, inflationary booms lay the groundwork for recession and depression. With more money available on the loan market, interest rates decline, and businesses are lured into making bad capital investments. Because the investments are not accompanied by corresponding increases in savings, capital costs will rise to meet increasing demand. The boom, therefore, must lead to a bust, a time of adjustment to correct previous malinvestments. If the government continues to inflate, then hyperinflation and eventually the total destruction of the currency will follow.

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In order to restore stability and integrity to money, Sennholz advocates monetary freedom, that is, the private issuing of coins and bank notes. A "parallel standard" of competing monies would replace the government monopoly. Legal tender laws would apply only to the issuers of currencies, who would be required to redeem their monies at face value. Thus, the government would be required to accept its fiat paper money at face value, but could not force it on anyone else.

A particular form of money, like any other economic good, will be driven out of the market if it fails to satisfy consumer demand. Given monetary freedom, individuals will likely choose gold as their money, as they have in the past. Gold is highly marketable, easily divisible, and cannot be "created" out of thin air by the government. Furthermore, gold does not require coercion to gain acceptance. As Sennholz states, "Gold does not need legal tender force; no honest money needs legal tender, but it needs to be free from government regulation, taxation, manipulation, intervention, and threat of confiscation." (p. 83)

In a section entitled, "False Solutions: Managed Money," Sennholz examines reform proposals of economists from the monetarist, supply side, and social credit camps. While the proposals vary widely, they all fail to take into account the main problem: the government money monopoly. Sennholz's critique of authors such as Milton Friedman, Robert Mundell, and Wickliffe B. Vennard is excellent, and though current Austrian proposals remain unmentioned, the section serves as a fine overview of the popular monetary solutions being set forth today.

Books which espouse sound economic analysis are essential if the present monetary system is to be reformed. Sennholz's *Money and Freedom* is such a book. It provides explanations of past mistakes and solutions to present problems. The clarity with which Sennholz expresses his ideas makes complicated economic ideas understandable to the reader, and even those who disagree with Sennholz will benefit from his analysis. The government money monopoly has failed. Only when freedom is restored to money will a sound currency be established. □

DESTROYING DEMOCRACY: HOW GOVERNMENT FUNDS PARTISAN POLITICS

by James T. Bennett and Thomas J. DiLorenzo

Cato Institute, 224 Second St., SE, Washington, D.C. 20003 • 1985 • 561 pages, $24.95 cloth, $11.95 paperback

Reviewed by Daniel Klein

Destroying Democracy provides a detailed account of the thousands of hidden and diverse ways Federal agencies hand over billions of taxpayer dollars to special interest advocacy organizations. This practice subverts whatever fairness we may have in American politics. Moreover, it is against the law, as shown by passages from laws enacted by Congress and rulings of the Supreme Court.

Behind the facade of representative government, political bodies play a major role in shaping public opinion. They do so by funding special interests which, in turn, lobby for the handouts on which they depend. To obtain tax dollars, the special interest groups engage in a masquerade, claiming that their intent is to aid the less fortunate, advance the public interest, protect the consumer, improve the environment, uplift minorities, and so on. Actually, pressure groups use the taxpayers' money primarily to further their own interests.

"Virtually without exception, the recipients of government grants and contracts advocate greater governmental control over and intervention in the private sector, greater limitations on the right of private property, more planning by government, income redistribution, and political rather than private decision making." (The exceptions are a handful of right-wing organizations which have responded to the lure of political handouts.)

Some examples: One government agency gave a Ralph Nader "public interest research group" $1,287,000 in the period 1979-81. Jesse Jackson's People United to Save Humanity received more than $5 million during 1977-81 from the departments of Education, Labor, Health and Human Services, and Commerce. The National Organization of Women and its affiliates have received considerable grants, one

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of which (for $105,000) was used to finance a media campaign publicizing NOW's positions. Tom Hayden's Campaign for Economic Democracy was awarded $500,000, and its activist training arm, The Center for New Corporate Priorities, received a separate grant of $126,000.

This book details the realm of tax-funded politicking, and in so doing offers something much broader. Since most advocacy groups receive taxpayer support, the work serves as a handbook of hundreds of activist organizations, from the most remote grass-roots campaigns to the most prestigious Washington think tanks.

In addition to the text, there is a hundred-page appendix listing the recipient organizations, the Federal agency which gave the money, the amount, and the dates.

Before we can successfully oppose "the engineering of consent" we must identify the engineers and know how they operate. This book tells us. □

MAKING SENSE OF MARX

by Jon Elster

Cambridge University Press, 32 E. 57th Street, New York, NY 10022 • 1985 • 556 pages, $15.95 paperback

Reviewed by John K. Williams

This volume is the second contribution to a series, *Studies in Marxism and Social Theory,* being jointly published by the Cambridge University Press and the Editions de la Maison des Sciences de l'Homme. The editors of the series hope that it will "exemplify a new paradigm in the study of Marxist social theory," liberating such theory from what they describe as "the increasingly discredited . . . presuppositions" of Marxist orthodoxy.

Jon Elster—a Professor of Political Science at the University of Chicago and research director of the prestigious Oslo-based Institute for Social Research—designates himself a Marxist, albeit noting that the sense in which he feels able so to describe himself "has undergone a change over the years." Many readers may, however, wonder precisely what Elster's radically revised "Marxism" signifies. His scholarship is awesome; his language is precise; his argumentation is cogent. Yet his Marxism is to the writings of Marx what the ethereal smile of the Cheshire Cat is to that enchanting creature.

"For many readers," observes Elster, "Marxist economics will be more or less synonymous with the labour theory of value." One might challenge the term "synonymous" but one both could and should be excused for suggesting that this theory is central to the economic thought of Marx. One is thus somewhat relieved to discover that Elster concedes this centrality. Yet he bluntly asserts that "the theory is useless at best, harmful and misleading at its not infrequent worst," and proceeds rigorously to defend this judgment.

Elster's unqualified rejection of both the special and general labor theory of value is extraordinarily significant. The grand old man of Marxist economics in the United States—Paul Sweezy—is indubitably correct to insist that Marxist economics without the labor theory of value and the associated concept of surplus value is *Hamlet* without the Prince. The insistence of Marx that the capitalist mode of production necessarily involves the exploitation of labor by capital depends, *in his economic writings,* utterly upon the labor theory of value. Yet Elster firmly and decisively rejects that theory.

Elster's criticisms of Marx's class analysis of capitalist society are no less stringent than his criticisms of the labor theory of value. Yet he clearly is anxious to retrieve the notion of class conflict from the dismembered cadaver left when his dissecting exercises are complete. Sadly, Elster is either unaware of, or chooses to ignore, the class (or "caste") war stressed by classically liberal thinkers, particularly such nineteenth-century French thinkers as Jean Baptiste Say, Gustave de Molinari, Charles Comte, and Alexis de Tocqueville. Indeed Thomas Paine, writing in 1792 of the United States, insisted that "[t]here are two distinct classes of men in the Nation, those who pay taxes and those who receive and live upon the taxes." As against the "high Tories," the classical liberals perceived in any government able to appropriate goods and services the root cause of social division and "class" struggle, insisting that unless structures limiting the power of government could be created, conflict between

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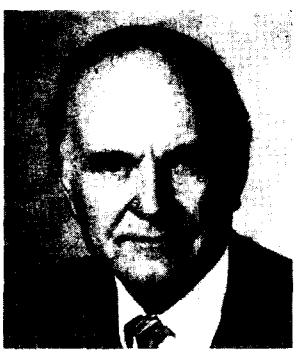
those controlling the statist apparatus and those subject to that apparatus is inevitable.

A case can be made for asserting that the insights Elster most values in Marx are remarkably familiar to students of the freedom philosophy. No student of Ludwig von Mises or reader of Joseph Schumpeter will be amazed to learn that the world studied by economists is a world of dynamic and ongoing change. No person familiar with the rich heritage of classical liberalism will find astonishing the notion that, the moment government's task is perceived as going beyond that of defending through laws equally applicable to all the equal rights of all, special interest groups seeking to forge an unholy alliance with government will emerge, each warring against the others. No reader of Adam Smith will greet the insistence that a vital relationship exists between a nation's political and economic structures with other than a somewhat tired, "So what's new?"—for after all, the market economy rests upon precisely defined and efficiently enforced private property rights.

In short, Elster perhaps unwittingly raises the extraordinary but enchanting possibility that what the editors of the series to which his book is a singularly distinguished contribution wish to establish—namely, "what is true and important in Marxism"—might be aspects of the classical liberal heritage absorbed by the eclectic Marx. Be that as it may, Elster's volume is a work serious students of the freedom philosophy would do well carefully to read, thoughtfully to ponder, and mightily to enjoy! □

Money and Freedom
by Hans F. Sennholz



Money and Freedom is a remarkable study of money and some fateful errors of popular monetary doctrines. Professor Sennholz argues forcefully and convincingly that such control, which amounts to a money monopoly, causes monetary destruction.

Money and Freedom is published by Libertarian Press and is also available from The Foundation for Economic Education.

102 pages, paperback **$6.00**

Order from: The Foundation for Economic Education
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